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Contents

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ERRATUM

In the article by Mr. H.M.A.L. Hamaekers in the December 1985 issue, "The OECD Report on the Allocation of Central Management and Service Costs", the following corrections should be made:

Page 532, right-hand column:

Line 13 from bottom: "individual" should read "indirect"

Last line—"Holland" should read "that case" (referring to the Federal Republic of Germany).

INHALTSVERZEICHNIS

SOMMAIRE

U.S.A.:

New Delaware Law Facilitates Failsafe Planning

By William S. Conely and William G. Dodge

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The combination of attractive profit yields in United States operations and concern over political stability and protection of property abroad has contributed to a continuing high level of investment in the United States. Legislation which was recently enacted in Delaware may also enhance the use of the United States in "failsafe" planning, even for assets located outside of the United States.

"Failsafe" planning refers to strategies adopted to minimize an international investor's risk of loss of an asset through actions taken by his home government, by that of a country serving an intermediary holding function (e.g. the Netherlands Antilles, Cayman Islands), or by the United States blocking transactions or vesting assets in reaction to developments abroad. A number of approaches have been developed as failsafe mechanisms including the transfer of assets pursuant to debt foreclosure, exercise of an option or redemption of stock, or changing the domicile of the corporation holding the assets. It is this last device to which the Delaware law is addressed.

THE NEW DELAWARE LAW

The new Delaware statute provides that a non-United States corporation[1] may change its status through either "domestication" or "change of domicile".

Domestication

Under section 388(b) of the Delaware Corporation Law, a non-United States corporation may become *domesticated* in Delaware by filing with the Secretary of State (i) a certificate of domestication signed by any authorized corporation officer, director, trustee, manager, partner or other equivalent person and (ii) a certificate of incorporation.

The certificate of domestication must certify (i) the date on which, and jurisdiction where, the corporation was first formed or incorporated, (ii) the name of the corporation immediately prior to the filing of the certificate of domestication, and (iii) the jurisdiction that constituted the seat, *siège social*, or principal place of business or central administration of the corporation immediately prior to the filing of the certificate of domestication. After filing the certificates of domestication and incorporation, the foreign entity is domesticated in Delaware and subject thereafter to all the provisions of the Delaware Corporation Law.

Change of domicile

The *change of domicile* provisions contained in section 389 of the Delaware Corporation Law provide a less permanent response to unsettled conditions abroad than does domestication. A transfer of domicile into Delaware may only occur in the event of an emergency condition in the jurisdiction, the law of which governs the internal affairs of the corporation (the governing jurisdiction) and may continue only so long as the emergency conditions require. The term "emergency condition" encompasses war, revolution, invasion, and extended rioting; expropriation, nationalization or confiscation of a material part of the assets of the corporation; impairment of the institution of private property; the taking of any action under the laws of the United States whereby persons resident in the governing jurisdiction might be treated as enemies or otherwise restricted under the laws of the United States relating to trading with enemies; or the immediate threat of any of the above. Any corporation which has transferred its domicile to Delaware may voluntarily return to the governing jurisdiction merely by filing with the Secretary of State an appropriate application to withdraw.

To temporarily migrate, or transfer its domicile, the foreign corporation should submit to the Secretary of State, at least 30 days prior to the proposed transfer, the following documents:

1. a certified copy of its certificate of incorporation and bylaws;
2. a certificate evidencing its corporate existence issued by an authorized officer of the governing jurisdiction;
3. a list of persons authorized to serve as directors and officers in the event of a transfer; and
4. a signed certificate setting forth, among other tiems, (i) the name and address of the corporation's registered agent in Delaware, (ii) a description of its business; and (iii) an affirmation that the transfer is not expressly prohibited under the law by which the corporation's internal affairs are governed.

Thus, a foreign corporation may prepare in advance for a temporary transfer to Delaware, including reserving a name, so that on the occurrence of an "emergency condition", the corporation may transfer its domicile merely by means of a written communication to such effect by an authorized person (certainly one of the more efficient discretionary "triggering" actions avail-

1. Although this article limits its discussion of sections 338 and 389 of the Delaware Corporation Law to matters that apply to use of the provisions by a corporate entity, the provisions are available for use by partnerships, trusts, and foundations as well.

able). If the emergency conditions affect ordinary means of communication, such notification may be made by telegram, telex, or telecopy provided a duly-signed duplicate is filed within 30 days. Following the transfer of domicile, the corporation retains all of its powers and may be managed in accordance with the laws of the governing jurisdiction in effect *immediately prior to the transfer of domicile.*

U.S. TAX CONSEQUENCES

Domestication

A domesticated foreign corporation becomes a Delaware corporation and, as such, is subject to United States tax on its world-wide income. The actual domestication of the foreign corporation should be a tax-free reorganization (a mere change in identity, form, or place of organization) for United States tax purposes.

However, the "transfer" of the assets of the foreign corporation to the domesticated corporation would be subject to the Foreign Investment in Real Property Tax Act (FIRPTA), section 897, IRC, and the associated withholding rules under section 1445, IRC. That is, if the foreign corporation holds United States real property interests when it is domesticated, the transfer of those interests would be subject to United States tax unless protected by the tax-free reorganization provisions. Although such a transaction would appear to be tax-free under section 897(e), IRC, the IRS is empowered to issue regulations which could restrict the scope of this protection. Such regulations have not yet been issued. Until issued, the FIRPTA treatment of a domesticating foreign corporation will be uncertain unless confirmed by the IRS in a private ruling prior to the domestication.

The transfer of United States real property interests from the foreign corporation to the domesticated Delaware corporation, even in a tax-free reorganization, would be subject to withholding tax under section 1445, IRC, pursuant to Temp. Reg. 1.445-2T(d)(2)(ii)(A). This anomaly will probably exist until regulations are issued under section 897(e), IRC. However, the IRS could also be asked to address this point if a ruling were requested as above.

Change in domicile

A foreign corporation which has temporarily transferred its domicile to Delaware should be subject to United States tax under rules applicable to foreign corporations. If not engaged in a United States trade or business, it would be subject to withholding tax at the statutory 30% rate (or lower treaty rate, if applicable) on income from United States sources. However, if it were engaged in a United States trade or business, for example, because of active United States management or other activity in the United States, it would be subject tot United States tax at regular corporate rates on income effectively connected with the United States business. Non-effectively connected United States-source income would remain subject to the gross withholding tax. If engaged in a United States trade or business a portion, if not all, of dividends and interest paid outside the United States by the temporarily domiciled corporation would be subject to withholding at a rate of 30% (or lower treaty rate).

BLOCKING TRANSACTIONS AND VESTING ASSETS BY THE UNITED STATES

As mentioned earlier, investors undertake failsafe planning not only to counteract risk in their home country or intermediate countries, but also because of the risk that the United States will respond to developments abroad by vesting, or confiscating, foreign-owned assets or by blocking transactions involving such assets. Under the Trading with the Enemy Act (TEA), the United States may, in time of war, vest in the United States property of designated enemies and block any transaction with respect to such property. Similarly, the International Emergency Economic Powers Act of 1977 (IEEPA) allows the President to block or "freeze" assets in the event of a national emergency. For instance, Iranian assets were frozen under the IEEPA during the hostage crisis.

In many instances, domestication or change of domicile under Delaware law alone will probably not provide complete protection from the TEA and the IEEPA. Although the change of domicile provisions specifically provide that the domiciled corporation shall not "be deemed to be an enemy person or entity for any purpose", it is uncertain what effect this provision would have under federal law. In some cases, it may be advisable to supplement a change of domicile with a substantive shift of management to the United States and to take other steps to further shield the ultimate foreign owners from the TEA and the IEEPA. Nevertheless, the new Delaware laws are significant factors in failsafe planning, particularly given Delaware's importance as a state of incorporation, and they may serve a vital role in a foreign investor's overall failsafe strategy.

NIGERIA:

Reforming Sales Tax in Developing Countries

A Study of the Nigerian Sales Tax System

By Dr. Mahesh C. Purohit

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Most of this work was done by the author when he was a faculty member of the Department of Accounting, Ahmadu Bello University, Zaria, Nigeria. The author is thankful to Mr. John Shagbaor Hiangya and the Chief Inspector of Taxes, Department of Revenue, Government of Kaduna, for supplying useful information.

The objectives of this paper are to present the salient features of the sales tax system in Nigeria and to suggest reforms that could be attempted, keeping in mind the state of economic development of the country.

EVOLUTION OF SALES TAX

The history of sales tax in Nigeria dates back to 1953, when the Sales of Produce Taxation Act was enacted[1] and the government was empowered to impose a tax on the sale of specified commodities made to a Marketing Board or to a licensed buying agent.[2] However, the 1954 Constitution, for the first time, gave the regions a semi-autonomous existence and made specific provisions for them to impose a sales tax. The regions then assumed the 1953 enactment to have taken effect as a law of their respective regional assemblies. They abrogated and replaced the Act with their own separate and regional Produce Sales Tax Laws.[3]

The Federal Government enacted the Sales of Produce (Taxation) Act, 1957, to replace the Sales of Produce Taxation Act, 1953, and provided for a tax in the Federal Territory of Lagos, on sales of produce to the Western Region Marketing Board or any of the licensed buying agents.[4] The commodities taxed were cocoa, palm kernel and palm oil.

The Nigerian (Constitution) (Amendment) Order, 1959, introduced "Taxes on amount paid or payable on the sale or purchase of commodities" as an item on the exclusive legislative list.[5] Some of the commodities were, however, excepted: These were produce, hides and skins, petrol, and diesel oil. These exceptions gave the regions a share in the proceeds of taxation of the excepted commodities.[6] Item 35A of the 1959 Amendment was re-enacted as item 38 of the exclusive list of the Constitution of the Federation of Nigeria, 1960. As the tax on items, as listed above, was not specifically placed on the concurrent list, it found a place on the residual list in respect of which the regions could legislate.[7] The Commodity Boards Act, 1977, dissolved the Marketing Boards[8] and the Nigerian Produce Marketing Company Limited (which had, until now, administered the produce sales tax legislations) and replaced them with Commodity Boards for each important item of produce exported.[9]

The Constitution of 1979[10] which heralded the executive presidential form of government, omitted item 38 in its entirety as set out in both the 1960 and 1963 Constitutions. Though this omission did not show any intention to regard the imposition of a sales tax as a residual subject, it was interpreted to mean that the States did have the competence under the Constitution to legislate and impose tax on the supply of goods and services within the States.

The 1979 Constitution was in force for only four years when the armed forces replaced the government in a military coup on 31 December 1983. The new Federal Military Government promulgated the Constitution (Suspension and Modifications) Decree 1984[11] giving itself limitless powers "to make laws for the peace, order and good government of Nigeria or any part thereof with respect to any matter whatsoever". The Military Governor of a State, who is the sole legislator in the State, now exercises delegated authority. However, the Governor must seek the consent of the Fed-

1. Ordinance No. 12 of 1953.
2. Williams, F.R.A., *Submissions to Federal Court of Appeal Ibadan*, Alhaji Ayinke Aberuagbe et al. vs Ogun State, FCA/134/83/(1983).
3. For example, the Western Region passed the Procedure Sales Tax Law (No. 14 of 1957) after abrogating the Act. See Cap. 99 *Laws of Western Region of Nigeria* (1959).
4. Cap. 184, Vol. VI, *Laws of the Federation of Nigeria*, 1958.
5. Introduced as a new Item 35A.
6. Item 38.
7. See *Constitution of the Federation*, 1963, Exclusive Legislative List, Item 38.
8. The State Boards affected were the Northern States Marketing Board; the Western Nigeria Marketing Board; The East Central State Marketing Board; The Lagos State Marketing Board, the River State Marketing Board; The Benue-Plateau Marketing Board; and the Cross River State Marketing Board. The new Boards had exclusive rights of purchase of produce for export. Their exclusive rights did not extend to the domestic market. They could not therefore collect any produce sales tax. See *Commodity Boards Act, 1977*, §§ 5 & 6. See also, *Alhaja Aberuagba and 7 others v. Attorney General Ogun State*, FCA/1/34/83, Court of Appeal, Ibadan, 13/9/83.
9. The Board were – the Nigerian Cocoa Board with headquarters at Ibadan; the Nigerian Groundnut Board with headquarters at Kano; the Nigerian Cotton Board with headquarters at Funtua; the Nigerian Palm Produce Board with headquarters at Calabar; the Nigerian Rubber Board with headquarters in Benin; the Nigerian Grains Board with headquarters at Minna; and the Nigerian Tuber and Root Crops Board with headquarters in Makurd.
10. The Constitution of the Federal Republic of Nigeria, 1979.
11. Decree No. 1 of 1984.

eral military Government before making any law, even with respect to matters on the concurrent legislative list.

The effect of the above Decree is to give the Federal Government legislative powers over all matters including State sales taxation, and when a Military Governor is desirous of enacting any law on sales taxation, he will first seek clearance from the Federal Military Government. The Governor is, however, not likely to encounter any problem as the Federal Military Government has made it clear that the States have to intensify their efforts to generate more internal revenue in light of the gloomy market for Nigerian crude oil.

Existing structure

Notwithstanding the jurisdictional problems of States' rights to levy sales tax, ten of the Nigerian States, viz. Anambra, Bendel, Benue, Cross River, Kaduna, Lagos, Ogun, Ondo, Oyo and Plateau, are presently levying sales tax. The tax structure of all the States is almost similar (Table 1). All of them impose a retail sales tax with no exemption limit.[12] The rate of tax, however, varies from 2% to 10%. The low rate of 2% is levied only in Cross River. Three of the States, viz. Anambra, Oyo and Plateau, tax commodities at the rate of 5%.

The tax is levied only on a few select commodities. These are generally luxury articles or addiction items (e.g. beer, liquor and tobacco). In addition, the tax is levied on petroleum products in three States, namely Ogu, Ondo and Oyo. The sales tax structure of these three States is likely to be more productive and income-elastic as the consumption of petroleum products is very high. The coverage of the tax has been further increased by including a tax on advertisements and services. Whereas Anambra is the only State which levies a tax on advertisements and other mass media, most of the States have attempted to levy a tax on services. All ten States resorting to a sales tax are levying a tax on hotels and catering services. However,

12. While no formal exclusion is provided in typical retail sales taxes in developed countries, exclusion is common in all forms of sales taxes in developing countries. Exemption of firms below a specified figure is the most common approach. See, Due, John F., "The Exclusion of Small Firms from Sales and Related Taxes", *Public Finance,* No. 2, 202-212 (1984).

TABLE I

SALES TAX RATES IN NIGERIA
(As of 1 April 1985)

Commodities and services	*Anambra*[1]	*Bendel*	*Benue*	*Cross River*[3]	*Kaduna*	*Lagos*[4]	*Ogun*[5]	*Ondo*[6]	*Oyo*	*Plateau*
Flour	–	–	–	2	–	–	–	–	–	–
Soft drinks	5	10	10	2	10	10	–	10	5	5
Beer and liquor	5	10	10	2	15	10	10	10	5	5[7]
Cigarettes and tobacco	5	10	10	2	15	10	10	10	5	5
Perfume and cosmetics	5	5	–	–	10	10	–	10	–	5
Foam	–	–	–	2	–	–	–	–	–	–
Plastic products	–	–	–	2	–	–	–	–	–	–
Paints	5	2	–	–	–	–	5	10	–	–
Cements	5	2	–	2[2]	–	–	–	–	–	–
Ceramic Products (including floor tiles)	–	–	–	2[2]	–	–	–	–	–	–
Motorcycles	–	–	–	2	–	–	–	–	–	–
Cars & other vehicles	–	–	–	2	–	–	–	–	–	–
Carpets and rugs	–	–	–	2	–	–	–	–	–	5
Fans	5	2	–	2	–	–	–	10	–	–
Tape recorders	5	2	–	2	10	–	–	10	–	–
Cameras	–	–	–	2	10	–	–	–	–	–
Refrigerators and deep-freezers	5	2	–	2	10	–	–	10	–	–
Upholstery products	–	–	–	2	–	–	–	–	–	–
Television sets	5	2	–	2	10	–	–	10	–	5
Video sets	5	2	–	2	10	–	–	10	–	5
Air-conditioners	5	2	–	2	–	–	–	10	–	5
Jewellery	5	5	–	–	–	10	–	10	–	5
Cinema	–	–	–	–	–	–	–	–	–	5
Petrol	–	–	–	–	–	–	1K/P.Lit	10	1K/P.Lit	–
Diesel oil	–	–	–	–	–	–	1K/P.Lit	10	1K/P.Lit	–
Other petroleum products	–	–	–	–	–	–	1K/P.Lit	10	1K/P.Lit	–
Advertissements in the press, radio, T.V. other mass media	10	–	–	–	–	–	–	–	–	–
Hotels and catering services	5	5	10	2	10	10	10	10	5	5
Laundry, other ancillary services	5	–	–	–	–	–	–	–	–	–

Notes: K/P. refers to a specific rate of Kobo per litre.

1. Anambra State also taxes 5% of turnover on other sales and services, e.g. sales and service of motor vehicles. This kind of taxation has a negative effect, as consumers will prefer patronising dealers in nearby States where the sale of such items and services are not taxed. Electricity is also taxed under the Anambra State Law and this will no doubt affect industries that have very high rates of electricity consumption.
2. Indicates tax levy on all items referred to as "building material".
3. Reference period 1 Jan. 1982, as given in the Sales Tax Law, 1982 (Bill No. 23 (81-82)), Cross River State.
4. Reference period 19.7.82, as given in Law No. 7 of 1982 of Lagos State.
5. Reference period 25.2.82, as shown in the sales tax law, 1982 (No. 2, 1982) Ogun State, House of Assembly.
6. The rates are for the period 1983-84, as given in the Sales Tax Law, 1982.
7. The tax on the item is not being collected so far, the rate however, exists.

Anambra is the only State which levies a tax on laundry and other ancillary services.

The majority of the States have one single rate of tax which is levied on all the taxable commodities. The rate of tax is 5% in half of the States levying a sales tax. Some of the States have higher rates of 7 and 10%.

As opposed to a single rate of tax, some of the States have resorted to rate differentials according to the type of commodity. These States are Anambra, Bendel and Kaduna. In Anambra advertisements in the press and the mass media have been excluded for taxation at the higher rate of 10% (when the general rate is 5% on all the taxable commodities). In Bendel there are three rate categories: 2% on raw materials and electronic items; 5% on services; and 10% on soft-drinks and addiction items. In Kaduna beer and liquor, as well as cigarettes and tobacco, have been singled out for taxation at 15% (whereas, the general rate is 10% in this State).

All States levying a sales tax have adopted an ad valorem levy. Only two of the States, namely, Ogun and Oyo have decided to levy a specific tax on petroleum products. Ondo, which levies a tax on petrol and petroleum products, has adopted an ad valorem levy. Therefore, its tax yield would be elastic as compared to the other two States which levy tax on petroleum products.

Although the States levy a retail sales tax, many of the Nigerian States have devised their operations in such a way that, in effect, the tax structure is working like a tax on wholesale sales only. This is due to the fact that the structure of markets in Nigeria presents a typical dualistic economy. On the one hand, we find very big departmental stores and five-star hotels, on the other hand, there are unorganized markets full of small roadside shops, inns and kiosks. It is very difficult to administer a retail sales tax under such a market structure. Obviously, many of the States collect the tax from big department stores, hotels and gas stations, and have levied the tax on wholesalers. The tax is also levied on manufacturers. In practice, therefore, the tax is collected on the first sale of the commodity in the State. In fact, in some of the States, cooperation is being sought from the manufacturers residing in other States to supply them with the information and, if possible, to collect the tax from them as "exporters" of the goods to their State.

Revenue importance

Sales tax as a fiscal measure is a relatively new instrument in the fiscal armory of the Nigerian States. Besides, as is the case with most of the economic statistics in Nigeria, data relating to sales tax yield are not available in any published form. However, to illustrate the possible growth in revenue from sales tax, I present its revenue in Plateau State in Table II. The yield from a sales tax in this State shows that, within one year, the tax has increased from ₦ 20,000 in June 1983 to ₦ 39,000. This represents an increase of more than 50%. Also, the tax as a percentage of a State's tax revenue has increased from 1.36% in June-December, 1983 (average), to 1.93% in January-June, 1984 (average). The above data indicates that the importance of the tax is bound to grow in Nigeria in times to come.

TABLE II

Fiscal importance of sales tax in Plateau State

Year / Month	*Yields from sales tax* (₦ 000's)	*Yields from sales tax* Equivalent to $ 000's	*Sales tax as a percentage of State's tax revenue*
1983			
June	20	22.60	2.07
July	14	15.82	1.53
August	4	4.52	0.47
September	14	15.82	1.40
October	22	24.86	2.24
November	20	22.60	1.78
December	13	14.69	1.41
Average (June–December)	13.37	15.11	1.36
1984			
January	9	10.17	0.68
February	17	19.21	1.49
March	31	35.03	2.75
April	17	19.21	1.93
May	39	44.07	3.19
June	20	22.60	1.53
Average (January–June)	20.16	22.78	1.93

Source: Hiangya, John Shagboar, *Sales Tax in Plateau State*, MBA Dissertation, Ahmadu Bello University, Zaria, 1985.

Administration of the tax

Administration of a sales tax in Nigeria is done either through the State Tax Boards or through the Inland Revenue Boards. Some of the States, like Bendel and Ogun, are using the State Tax Boards and some of them, such as Lagos, use Inland Revenue Boards to administer the sales tax. As the structure of these Boards is vertical and the involvement of the local bodies is insignificant, given the market structure, it is possible for the Boards to collect sales taxes from big departments stores, as well as big hotels and gas stations, only. Even in these cases the experience in many of the States shows that the rate of non-compliance is very high. Very recently, in Lagos State, the government used police and armed soldiers to seal up hotels to compel them to remit the tax collected to government.[13] Similarly, in Kaduna State the Governor himself visited the shops and made many of them close until the tax was paid. Such instances do show the ineffectiveness of the existing administrative organiza-

13. See *Evening Times*, 19 November 1984, 1.

tion and lack of compliance. Further, it would be very difficult to collect the taxes from small shops, hotels and inns.

To ensure proper compliance, therefore, it will be necessary to involve the local government councils in the administration and the enforcement of the sales tax.

The close association with the consumers and the retailers will help induce compliance with the tax.

With a view toward having effective administration, tax penalties have been prescribed for offenses against the various State sales tax laws. Some of the offenses for which penalties have been prescribed are: contravention or failure to comply with the provisions of the law;[14] unlawful collection of tax from purchaser;[15] evasion of tax;[16] failure to apply for registration; submission of incorrect returns or accounts; non-payment of tax collected;[17] and refusal to answer any question put by the Chairman of the Board of Inland Revenue, or failure to produce for inspection any relevant document.[18] Prescribed penalties range from ₦ 1,000 ($ 1,290), for contravention or failure to comply with the law in States such as Lagos, Ogun, Bendel and Cross River, to ₦ 500 ($ 645) or imprisonment for a period of not less than two years in States such as Ondo. Similarly, in Cross River the evasion of tax, or attempt to evade tax, attracts imprisonment for two years or a fine of ₦ 2,000 ($ 2,580) or both.

In the States of Bendel and Ogun, the penalty is imprisonment for one year and forfeiture of an amount double the amount of the tax.[19]

The penalties prescribed in the various sales tax laws are not likely to deter offenders, as they are not stringent enough. Experience in many of the States has clearly shown that prescribed penalties and methods of enforcing compliance with the law, as provided in the law, is of little or no effect. The States should treat the tax offenses as offenses constituting economic sabotage and, thus, attracting serious penalties.

TABLE III

Cost of sales tax collection in Plateau State

Month/Year	*Cost of collection (₦ 000's)*	*Equivalent to $ 000's*	*Cost as a percentage of sales tax yield*
1983			
June	2,564	3,330.64	12.52
July	1,064	1,382.14	7.43
August	1,058	1,374.34	26.37
September	1,065	1,383.44	7.38
October	1,070	1,389.93	4.86
November	1,085	1,409.42	5.52
December	1,058	1,374.34	8.39
1984			
January	1,080	1,402.92	12.20
February	1,064	1,382.14	6.12
March	1,065	1,383.44	3.46
April	1,070	1,389.93	6.28
May	1,085	1,409.42	2.75
June	1,064	1,382.14	5.20

Source: As given in Table II.

Cost of collection

As the tax has not been operative for a long time, and as no data are available on the operation of the tax, it is not possible to analyze the cost-trend of collection. However, the data available for Plateau State, as given in Table III, show that the expenditure has been to the tune of ₦ 2,564 (about 12.52% of the sales tax yield), in the first month of its operation. Over a period the cost has declined to a greater extent. In fact, by May 1984, the cost was as low as 2.75% of the sales tax yield. It is important to note that with some additional expenditure towards proper enforcement of the tax the cost of collection in the initial state may increase, but would bring a greater yield in later periods.

Objectives of tax reform

The above analysis of the structure of the sales tax in Nigeria suggests that the evolution of the tax is still in the preliminary stage. As the financial requirements and the urge for financial autonomy will apply pressure to the States, this source could be used to further mobilize the resources. However, we have to view the sales tax structure in a specific setting that would be relevant for the States' taxation policy in a Nigerian context and, for that matter, in any developing country having a federation. First, the tax system of a State is a sub-set of the country. Hence, it is restricted to activities and transactions that take place within its borders. Also there are significant differences between building a regional tax system (the sub-set) and guiding the overall national tax policy. In the regional tax system, we must always keep in mind the possibility of diversion of trade and investment. This may sometimes lead us to follow the average policy of the neighboring States.[20] Accordingly, we could keep the following criteria in mind, while referring to the tax structure.

a. *Growth objectives*. The tax policy should be able to raise enough resources for the development of the State. Accordingly, it should aim at having a tax structure that would be more income-elastic.

14. *Sales Tax Law*, No. 7 of Lagos State, 1982, § 10; Petroleum *Tax Law*, Oyo State § 10(1); *Sales Tax Law*, No. 9 of Bendel State, 1982, § 14(1); *Sales Tax Law* No. 2 of Ogun State, 1982, § 14(1); *Purchase Tax Law*, No. 4 Ondo State, 1982, § 10(e); *Finance Law* (Cap. 53) Laws of Eastern Nigerian, 1963, § 62, as amended by *Finance Law (Amendment)* Law No. 1, 1983, Anambra State.
15. *Sales Tax Law*, Ogun State and *Sales Tax Law*, Bendel, § 15(1).
16. Id. § 20, *Sales Tax Law* No. 7 of 1982, Cross River State, § 23.
17. *Sales Tax Law*, 1982, § 19, Cross River, *Purchase Tax Law*, 1982, Ondo State § 10(a)-(d). See also Cross River State § 20 on False Returns.
18. *Sales Tax Law*, 1981, § 18, Cross River State.
19. See, for examplew, *Sales Tax Law*, 1982, § 25, Cross River State.
20. See, for example, NIPFP (1981), *Sales Tax System in Bihar*, Somaiya Publications, Bombay.

b. *Equity consideration.* The structure should fulfill the criteria of both the horizontal and vertical equity. It should thus be casting proportionately larger burdens on the better-off sections of the population, and should not be taking more than a token contribution from the poorer sections of the society.

c. *Administrative expediency.* It should be so administered as to cause the least harassment of the taxpayers and to result in low compliance costs.

d. *Coordination.* It should follow the national objectives of the overall tax policy and should be in consonance, in essential respects, with the structures prevailing in the neighboring States.

Suggested reforms

Keeping in view the above objectives,[21] the existing structure of the sales tax could be reformed on the lines suggested below:

Uniformity in the tax structure

One of the problems confronting the existing structure of the sales tax in Nigerian States relates to the lack of uniformity of rates. The diversity of rates causes diversion of trade, as well as shifting of manufacturing activity from one State to another. It is important, therefore, that some attempt be made to bring uniformity in the rate structure of the sales tax. One such possibility is to prepare a model sales tax structure for the federation as a whole. This could be adopted by the States with State-specific variations.

Levy of a central sales tax

A second important reform in the sales tax structure of Nigeria would relate to the taxation of inter-state sales. This is important because, in a federal set-up, sales tax does not remain a purely intra-state problem. A commodity may undergo several sales in more than one State before it reaches the hands of a consumer. Taxation or non-taxation of an intra-state sale effects interstate movements of commodities. With a view to ensuring free flow of goods, avoiding unnecessary and uneconomic movement of goods, and checking discriminatory taxation, the following problems must be solved for the Nigerian sales tax system:

i. defining an inter-state sale;
ii. taxation of inter-state sales to avoid multiple taxation and to deny it a privileged position; and
iii. avoiding multiple taxation of commodities entering into inter-state trade or commerce.

Under the federal system it is important that all the above aspects are carefully reviewed and the States are prohibited from levying any tax on inter-state subjects.

Here it is pertinent to note that, although the flow of inter-state commerce would be at its maximum if such commerce were immune from taxation, the economic unity of the country demands that the inter-state trade should not be left free of tax.[22] If no taxes are levied on inter-state trade, the consumer would get out-of-state goods more cheaply than local goods, and local dealers would suffer a competitive disadvantage as compared to outside dealers. Consequently, the immunity of inter-state trade would create artificial channels of trade by putting local businesses at a disadvantage and would encourage economic waste in transportation by inducing persons to make their purchases out-of-state, tax-free. In an attempt to avoid these problems the tax should be levied on inter-state sales in such a way that they do not bear a heavier burden than the local products, and that the local products should not bear a heavier burden than the commodities from the other states of the federation.

Point of levy and exemption limit

An analysis of the sales tax systems prevalent in the developing countries reveals that when the federal government is empowered to levy the tax, the manufacturers' form of sales tax is levied by most of the African countries.[23] However, when the States are empowered to levy the tax, the different forms in use are: value-added tax (VAT), multi-point turnover tax and a single-point tax. In spite of the economic arguments for adopting VAT and retail sales tax, it is important to note that a very efficient tax administration and a high level of tax compliance on the part of the dealers are prerequisites for the effective operation of a VAT, as well as a retail sales tax. The multi-point turnover tax is easiest to administer, but it is well known for its adverse economic effects.

The administrators point out two important drawbacks in the last-point tax as compared to the first-point tax.[24] First, it is said to be inconvenient to administer because the number of dealers that have to be registered is very large under this system of sales taxation. And second,

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21. For a comparison of the criteria set out by Prof. Due, see Due, J.F., (1960), *State Sales Tax Administration*, Public Administration Service, Illinois, 136; and Due, J.F., (1950), "Retail Sales Taxation in Theory and Practice", *National Tax Journal*, December, 318.

22. It is ueful to note that in the Indian Federation there is a Central Sales Tax Act which levies tax on such transactions. It prescribes two different rates of tax for inter-state transactions: 4% on inter-state transactions to registered dealers who would once more pay the State Sales Tax and a higher rate of 10% on inter-state sales to unregistered dealers. The higher rate chargeable to sales to unregistered dealers is because of the face that no tax is charged by the importing State on the non-registered dealer. The higher rate, therefore, deprives the unregistered dealer from entering into inter-state trade for any competitive advantage; the discrimination between the registered and unregistered dealer makes them at par. See Purohit, Mahesh C., "Structure of Sales Taxes in India", *Economic and Political Weekly*, 21 August 1982, 1365-1375.

23. Cnossen, Sijbren, "Sales and Excise System of the World", *Finanzarchiv*, Vol. 33, (1975), 177-236.

24. When the tax is imposed on the sale by the first registered dealer in the State, it is known as the first-point tax and when the last registered dealer sells commodities either to the consumers or to the unregistered dealers, any tax on the sale by this last registered dealer is called the last-point tax.

the last-point tax is often evaded through the creation of bogus registered dealers to whom sales vouchers are made out.

These arguments are, however, not very convincing. In fact, it is a mistaken notion that the number of dealers is reduced under the first-point tax. As the number of registered dealers depends upon the prescription of an exemption-limit, all those with turnover above that limit will have to be registered and assessed. The number of dealers would be exactly the same under the two types of sales taxes. Further, the argument of less evasion of tax under the first-point tax is also not tenable. In fact, the system of "bogus dealers" in the last-point and the "bill trading" under the first-point tax are similar in nature.

In contrast to the above, in modern economic theory, it is well accepted that the last-point tax is clearly preferable because (a) this tax does not cause cascading and at the same time (b) covers value-added up to the final stage, in contrast to first-point tax.

In view of the above economic arguments against the first-point tax and the administrative arguments against the last-point tax, it is recommended that we should have an admixture of the two systems. In regard to those commodities that (i) have no fixed trade channels, (ii) have difficult traceability after the first-point and (iii) do not have a very large value-added after the manufacturing stage, it may be administratively convenient to levy a tax at the manufacturer's level. But, in all other cases the point of levy should be shifted as far away as possible from the manufacturing stage to the retail stage. Under the present state of economic development in Nigeria, it would be useful to tax the commodities at the level of wholesalers and/or the level of department stores. This could be done by fixing the exemption-limit of registration of dealers at a higher level of say, ₦ 100,000 per annum. The tax should be levied at this point. If the dealer at this level has bought goods which have already borne the tax, (because some commodities could be taxed at the first-point) no tax need be levied for that part of the turnover.

Basic procedures for enforcement

The proper enforcement of taxes requires evolving basic procedures related to the structure of tax. With regard to the sales tax, there are some important procedural regulations that have to be formulated before the tax is levied. As the experience of most of the countries suggests, lack of proper enforcement creates serious problems in the implementation of the tax. It causes a large amount of evasion of the tax which affects the elasticity of conscience of the taxpayer and ultimately increases the evasion of tax to a greater extent.[25]

The enforcement of the first-point sales tax is based on the information received from the importing ports/stations and the declarations (or certificates) given by the first dealer to the next. The latter dealer on the strength of this document (declarations or certificates) claims exemption from tax liability. The experience shows that the tax avoidance increases if the declarations are not cross-verified. It is, therefore, extremely important to evolve requisite procedures for verification of the documents issued by the first dealer to the other dealers.

Management information system

Sales tax departments in most of the States in Nigeria do not have even preliminary information available to the tax administrators. In fact, it would not be an exaggeration to say that these departments do not have any management information system; data are not being collected in a systematic manner or regularly. In the absence of an adequate information system any evaluation of the existing structure of tax or an estimate of the impact of any policy changes becomes impossible. It is, therefore, important that steps should be taken to evolve some management information system. To begin with, the department should collect information at least on the following aspects:

(i) commodity-wise turnover;
(ii) tax yield by commodities;
(iii) Distribution of dealers by size and tax yield; and
(iv) yearly assessments, collection and information on the flow of goods across State borders.

The information on the above aspects is necessary for the proper enforcement of the tax and for the evaluation of the administration as well as the effect of the tax.

Conclusion

An analysis of the different systems of sales tax prevalent in developing countries suggests that most of the African countries have adopted manufacturers' form of sales tax. Such a tax could be effectively implemented by a unitary form of government. This could be properly administered even when the tax is levied by the Union (Federal) Government. In Nigeria, however, sales tax is a State subject. When States are empowered to levy a sales tax it is administratively convenient and economically rational to have a sales tax at the manufacturers' or wholesalers' level. With a view to avoiding the defects of this system, it is useful to have a higher turnover exemption for the dealers who bear the impact of the tax.

As the existing structure of the sales tax in Nigeria is of recent origin, the analysis of the structure presented in the above paragraphs suggests that, from the point of view of objectives of growth, equity, administrative expediency and co-ordination, it is essential: to have a federal sales tax on the inter-state transactions to achieve uniformity in the rate structure; to levy an admixture of the first- and last-point tax; to evolve proper procedures for enforcement of the tax; and to have a properly designed management information system.

25. it is important to note that the evasion of sales tax in India varies from 5% to 85%; the magnitude varies with the type of commodity. See Chelliah, R.J., Purohit, M.C., *Information System and Evasion of Sales Tax in Tamil Nadu*, NIPFP, New Delhi, (1985).

INDIA:

Is Tax Avoidance Merging into Tax Evasion?

A Change in the Judiciaries' Approach to Tax Avoidance

By Parimal M. Parikh

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He has written a book entitled *India – Taxes and Investment Opportunities* published in June 1984 by International Tax and Investment Center Inc., New York, U.S.A.

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Mr. Parikh's article depicts a major change in the Supreme Court of India's attitude concerning tax avoidance.

Beginning with the taxpayer's victory in the first McDowell case, and the subsequent legislative response, the reader is prepared for the decisive break with tradition in the second McDowell case.

Thereafter, Mr. Parikh sets forth the specific holding in the second Mc Dowell case.

With the pronouncement of the second case the Supreme Court sounds a bell that continues to reverberate and cause pause for thought throughout this rapidly changing country.

In summation, a concise, yet complete, history of the court's evolution concerning tax avoidance is provided. The *Westminster* decision is presented, interpreted, and finally discarded with the cases of *Ramsay Ltd.; Burmah Oil Company Ltd.; Furniss;* and the controlling second *McDowell and Co. Ltd.* case.

INTRODUCTION

A five member constitution bench of the Supreme Court of India in a second McDowell and Co. Ltd. case (hereinafter "McDowell"), on 17 April 1985, dismissed the appeal. This judgment reported in (1985) 154 ITR 148 has highlighted the changing judicial attitude to the concept of tax avoidance and put at par with tax evasion.

According to this judgment, tax planning may be legitimate provided it is within the framework of the law. Colorable devices cannot be part of tax planning and it is wrong to encourage or entertain the belief that it is honorable to avoid the payment of tax by dubious methods. It is the obligation of every citizen to pay taxes honestly without resorting to subterfuges.

THE FIRST CASE

The issues in McDowell did not relate to direct taxes; they were concerned with sales tax, which is an indirect tax. In India, among various other taxes, sales tax is payable by the seller of certain items on the gross value of the turnover. The excise duty is payable by the manufacturer of a product on the goods manufactured and cleared through his factory. Thus, excise duty payable by the manufacturer is includable in the term "turnover" for the purpose of calculating sales tax.

THE FACTS

The facts of McDowell are summarized as follows:
McDowell was a licensed manufacturer of liquor. Excise duty under the State Excise Act and its sister enactments is leviable on the manufacture of liquor and the manufacturer cannot remove the same from the distillery unless the duty imposed under the Excise Act is paid. The purchasers of the liquor from McDowell's distillery obtained distillery passes for release of liquor and, after the payment of excise duty by the purchaser, the bill of sale or invoice was prepared by the distillery showing the price of liquor, but excluding excise duty. The books of account of McDowell did not contain any reference to excise duty paid by the purchaser. It paid sales tax on the basis of its turnover excluding excise duty. Later, the Commercial Tax Officer sought to reassess McDowell on the ground that excise duty was not included in the turnover for computation of sales tax liability. This action of the Commercial Tax Officer was challenged by McDowell before the High Court which dismissed the petition.

The matter was appealed to the Supreme Court which held in favor of McDowell that on the facts of the case the intending purchasers of the liquor who seek to obtain distillery passes are also legally responsible for the payment of excise duty which is collected from them by the authorities of the Excise Department. The Supreme Court came to the conclusion that excise duty did not go into the common till of McDowell and did not become a part of the circulating capital. Therefore, the sales tax authorities were not competent to include in the turnover of McDowell excise duty which was charged by it, but which was paid directly to the excise authorities by the purchasers of the liquor. This judgment was delivered on 25 October 1976.

THE SECOND CASE

Subsequent to the above judgement, Rules 76 and 79 of the Distillery Rules were amended with effect from 4 August 1981. Rule 76(a) now provides that no spirit or liquor manufactured or stored shall be removed from the distillery unless excise duty, as specified in Rule 6, has been paid by a holder of a D-2 license prior to said removal.

It was not disputed that McDowell was the holder of a D-2 license under the Law. Rule 79(1) of the Distillery Rules provides that on payment of excise duty by the holder of a D-2 license, a distillery pass for the removal of the spirit fit for human consumption may be granted in favor of the specified persons.

On the basis of the amended Rules 76 and 79 of the Distillery Rules, the Commercial Tax Officer issued a notice to McDowell proposing inclusion of a sum of approximately 45 million rupees representing excise duty paid directly by the purchasers of the liquor for a part of the year. This action was challenged in a writ petition by McDowell before the High Court which held that excise duty formed part of the turnover and that the primary liability to pay excise duty was that of McDowell. It further found that the turnover related to liquor; excise duty which was payable by McDowell, but had by an amicable arrangement been paid by the purchaser, was actually a part of the turnover of McDowell and was therefore liable to be so included for determining liability for sales tax. The matter then came up again on appeal to the Supreme Court which doubted the correctness of its earlier decision in the case of McDowell and placed the matter before a larger bench.

THE DECISION OF THE SUPREME COURT

After hearing both parties and referring to a number of authorities, the Supreme Court observed that, though excise duty does not go into the common till, it is not correct to say that it does not become a part of the turnover. There is nothing in the Distillery Rules to detract from the position that payment of excise duty is the primary and exclusive obligation of the manufacturer and if payment has been made under a contract or arrangement by any other person, it would amount to the meeting of the obligation of the manufacturer and nothing more.

Payment of excise duty is a condition precedent to the removal of the liquor from the distillery, and payment by the purchaser of the liquor should be treated as having been made by or on behalf of the manufacturer. According to normal commercial practice, excise duty should have been reflected in McDowell's bill either as merged in the price or separately. In the hands of the purchaser, the cost of the liquor is what is charged by McDowell under its bill together with the excise duty which the purchaser has directly paid on the seller's account. The consideration for the sale of the liquor by McDowell is the total amount of sale price and excise duty and not merely what is reflected in the bill. Excise duty, though paid by the purchaser to meet the liability of McDowell is a part of the consideration for he sale and is includable in McDowell's turnover. The purchaser has paid excise duty only on behalf of the manufacturer. Turnover includes any sum charged or paid at the time of or before the delivery of goods and any sum charged by the dealer, whatever be the description, name or object thereof. Therefore, it is only the total consideration for the sale that is to be taken into account for determining the turnover. If, pursuant to a prior agreement, the legal liability of the manufacturer for the payment of excise duty is satisfied by the purchaser by direct payment to the excise authorities or to the State Exchequer, excise duty should form part of the turnover for the purpose of sales tax.

COMMENTS

In McDowell, their lordships have rebutted the arguments on behalf of the taxpayer that it is open to everyone to so arrange his affairs as to reduce the brunt of taxation to the minimum and such a process does not constitute tax evasion. In support of such a submission, taxpayers have been relying upon the judgement of the Supreme Court of India in the case of *Raman & Co.* (1968) 67 ITR 11, where it was held:

> The law does not oblige a trader to make the maximum profit that he can out of his trading transactions. Income which accrues to a trader is not made taxable as income accrued to him. Avoidance of tax liability by so arranging commercial affairs that charge of tax is distributed is not prohibited. A taxpayer may resort to a device to divert the income before it accrues or arises to him. Effectiveness of the device depends not upon considerations of morality, but on the operation of the Income-tax Act. Legislative injunction in taxing statutes may not, except on peril of penalty, be violated, but it may lawfully be circumvented.

Justice Reddy in this historic judgment of McDowell observed that the shortest definition of tax avoidance is "the art of dodging tax without breaking the law". He further observed, that during the period between the two World Wars a theory came to be propounded and developed that it was prefectly open for persons to evade (avoid) income tax if they could do so legally.

For some time it looked as if tax avoidance was even viewed with affection by the judiciary which also referred to Lord Summer's observation in *Fisher's Executors*:

> My Lords, the highest authorities have always recognised that the subject is entitled so to arrange his affairs as not to attract taxes imposed by the Crown, so far as he can do so within the law, and that he may legitimately claim the advantage of any expressed terms or any omissions that he can find in his favour in taxing Acts. In so doing, he neither comes under liability nor incurs blame.

Lord Tomlin, echoing what Lord Summer had said, observed in *Westminster*, (1936) AC 1, typifying the prevalent attitude towards tax avoidance at that time:

> Every man is entitled if he can to order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be. If he succeeds in ordering them so as to secure this result, then, however unappreciative the Commissioners of Inland Revenue or his fellow tax-gatherers may be of his ingenuity, he cannot be compelled to pay an increased tax.

After the Second World War the attitude of the courts toward avoidance of tax perceptibly changed and hardened as we find from observations of Lord Greene in *Lord Howard de Walden*, (1942) 1 K B 389, where, dealing with the construction of an anti-avoidance section, he said:

> For years a battle of manoeuvre has been waged between the legislature and those who are minded to throw the burden of taxation off their own shoulders on to those of their fellow subjects. In that battle, the Legislature has often been worsted by the skill, determination and resourcefulness of its opponents, of whom the present appellant has not been the least successful. It would not shock us in the least to find that the Legislature has determined to put an end to the struggle by imposing the severest of penalties. It scarcely lies in the month of the taxpayer who plays with fire to complain of burnt fingers.

Expressing the same sentiment and dissertating on the moral aspects of tax avoidance, Lord Simon in *Latilla,* (1943) AC 377, said:

> My Lords, of recent years much ingenuity has been expended in certain quarters in attempting to devise methods of disposition of income by which those who were prepared to adopt them might enjoy the benefits of residence in this country while receiving the equivalent of such income, without sharing in the appropriate burden of British taxation. Judicial dicta may be cited which point out that, however elaborate and artificial such methods may be, those who adopt them are "entitled" to do so. There is, of course, no doubt that they are within their legal rights, but that is no reason why their efforts, or those of the professional gentlemen who assist them in the matter, should be regarded as a commendable exercise of ingenuity or as a discharge of the duties of good citizenship. On the contrary, one result of such methods, if they succeed, is, of course, to increase pro tanto the load of tax on the shoulders of the great body of good citizens who do not desire, or do not know how, to adopt these manoeuvres.

The march of the law against tax avoidance schemes continued and has achieved a significant departure from the *Westminster* and the *Fisher Executors* principle. In *Ramsay Ltd.* (1982) AC 300, the House of Lords had to consider a scheme of tax avoidance which consisted of a series or a combination of transactions each of which was individually genuine, but the result of all was the avoidance of tax. Lord Wilberforce observed:

> Given that a document or transaction is genuine, the court cannot go behind it to some supposed underlying substance. This is the well known principle of *Inland Revenue Commissioners v. Duke of Westminster* (1936) AC 1. This is a cardinal principle, but it must not be overstated or overextended. While obliging the court to accept documents or transactions, found to be genuine, as such, it does not compel the court to look at a document or a transaction in blinkers, isolated from any context to which it properly belongs. If it can be seen that a document or transaction was intended to have effect as part of a nexus or series of transactions, or as an ingredient of a wider transaction intended as a whole, there is nothing in the doctrine to prevent it being so regarded; to do so is not to prefer form to substance, or substance to form. It is the task of the court to ascertain the legal nature of any transaction to which it is sought to attach a tax or a tax consequence and if that emerges from a series or combination of transactions, intended to operate as such, it is that series or combination which may be regarded.

He further said:

> While the techniques of tax avoidance progress and are technically improved, the courts are not obliged to stand still. Such immobility must result either in loss of tax, to the prejudice of other taxpayers, or to Parliamentary congestion or (most likely) to both. To force the courts to adopt, in relation to closely integrated situations, a step by step, dissecting, approach which the parties themselves may have negated, would be a denial rather than an affirmation of the true judicial process.

The significance of *Ramsay* as a turning point in the interpretation of tax laws in England and the departure from the strings of *Westminster* was explained in *Burmah Oil Company Ltd.*, (1982) STC 30, where Lord Diplock said:

> It would be disingenuous to suggest, and dangerous on the part of those who advise on elaborate tax-avoidance schemes to assume, that Ramsay's case did not mark a significant change in the approach adopted by this House in its judicial role to a pre-ordained series of transactions (whether or not they include the achievement of a legitimate commercial end) into which there are inserted steps that have no commercial purpose apart from the avoidance of a liability to tax, which in the absence of those particular steps would have been payable. The difference is in approach. It does not necessitate the overruling of any earlier decisions of this House; but it does involve recognising that Lord Tomlin's oft-quoted dictum in *IRC v. Duke of Westminster* (1936) AC 1 at 19 (1935), All ER Rep 259, at 267, "Every man is entitled if he can to order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be", tells us little or nothing as to what methods of ordering one's affairs will be recognised by the courts as effective to lessen the tax that would attach to them if business transactions were conducted in a straight forward way.

Lord Scarman said:

> First, it is of the utmost importance that the business community (and others, including their advisers) should appreciate, as my noble and learned friend Lord Diplock has emphasised, that Ramsay's case marks "a significant change in the approach adopted by this House in its judicial role" towards tax avoidance schemes. Secondly, it is now crucial when considering any such scheme to take the analysis far enough to determine where the profit, gain or loss is really to be found.

The winds of change continued to blow and Lord Brightman in *Furniss v. Dawson*, (1984) 1 All ER 530, reiterating Ramsay, observed:

> The fact that the court accepted that each step in a transaction was a genuine step producing its intended legal result did not confine the court to considering each step in isolation for the purpose of assessing the fiscal result.

He further said:

> My Lords, in my opinion, the rationale of the new approach is this. In a preplanned tax-saving scheme, no distinction is to be drawn for fiscal purposes, because none exists in reality, between (i) a series of steps which are followed through by virtue of an arrangement which falls short of a binding contract, and (ii) a like series of steps which are followed through because the participants are contractually bound to take each step seriatim. In a contractual case, the fiscal consequences will naturally fall to be assessed in the light of the contractually agreed results.

In *Furniss v. Dawson*, Lord Fraser explained the principle of *Ramsay* as follows:

> The true principle of the decision in Ramsay was that the fiscal consequences of a preordained series of transactions, intended to operate as such, are generally to be ascertained by considering the result of the series as a whole, and not by dissecting the scheme and considering each individual transaction separately.

CONCLUDING REMARKS

Thus, the principle of *Westminster* has been given a decent burial in that very country where the phrase "tax avoidance" had originated. The judicial attitude towards tax avoidance has changed and the smile, cynical or even affectionate though it might have been at one time, has now frozen into a deep frown. The courts are now concerning themselves not merely with the genuineness of a transaction, but with the intended effect of it on fiscal purposes. No one can now get away with a tax avoidance project with the mere statement that there is nothing illegal about it.

Justice Reddy, while delivering *McDowell*, being greatly influenced by the departure from principle of *Westminster* in Ramsay's case, observed:

> We now live in a welfare State whose financial needs, if backed by the law, have to be respected and met. We must recognise that there is, behind taxation laws, as much moral sanction as behind any other welfare legislation and it is a pretence to say that avoidance of taxation is not unethical and that it stands on no less moral plane than honest payment of taxation. In our view, the proper way to construe a taxing statute, while considering a device to avoid tax is not to ask whether the provisions should be construed literally or liberally, nor whether the transaction is not unreal and not prohibited by the statute, but whether the transaction is a device to avoid tax, and whether the transaction is such that the judicial process may accord its approval to it.

Going further still, he observed:

> It is neither fair nor desirable to expect the legislature to intervene and take care of every device and scheme to avoid taxation. It is upto the court to take stock to determine the nature of the new and sophisticated legal devices to avoid tax and consider whether the situation created by the devices could be related to the existing legislation with the aid of "emerging" techniques of interpretation to expose the devices for what they really are and to refuse to give judicial benediction.

The rationale for such a stand, Justice Reddy said, stemmed from the realization of the manifold evil consequences of tax avoidance. In his own words:

> The evil consequences of tax avoidance are manifold. First, there is substantial loss of much needed public revenue, particularly in a welfare State like ours. Next, there is the serious disturbance caused to the economy of the country by the piling up of mountains of black money*, directly causing inflation. Then there is "the large hidden loss" to the community as pointed out by Master Sheatcraft in 18 Modern Law Review 209 by some of the best brains in the country being involved in the perpetual war waged between the tax avoider and his expert team of advisers, lawyers and accountants on one side and the taxgatherer and his perhaps not-so-skillful advisers on the other side. Then again there is the "sense of injustice and inequality which tax avoidance arouses in the breasts of those who are unwilling or unable to profit by it". Last, but not the least is the ethics (to be precise, the lack of it) of transferring the burden of tax liability to the shoulders of the guileless, good citizens from those of the "artful dodgers".

The above account clearly establishes that tax avoidance schemes which strike at the spirit of the law would now be stuck down by the courts of law in India. But, the million dollar question which remains to be answered is, will this approach solve the problem of black money? Only time will tell!

* Unreported or undeclared money.

KOREAN PEOPLE'S DEMOCRATIC REPUBLIC:

Executive Decree Concerning the Joint Venture Act

Resolution by the Council of Ministers of 20 March 1985

Unofficial translation. Translation provided by Dr. Tibor Nagy, correspondent for Hungary

Contents

I. GENERAL PROVISIONS

(1) The purpose of this Executive Decree is to promote economic development and technological cooperation as well as increase trade with other countries through the precise execution of the Act on Joint Ventures of the Korean People's Democratic Republic.

(2) The Korean People's Democratic Republic supports the establishment of joint ventures between foreign companies, enterprises, and other economic entities or individuals and domestic companies and enterprises in the territory of the Republic based on the principle of equality and mutual benefit.

(3) In the Korean People's Democratic Republic such a cooperation could be established in such fields of the national economy as electronics, automatization, metallurgy, resource development, machinery, chemistry, food-processing, textiles, consumer goods, construction, transportation, tourism, etc.

(4) The joint ventures established in the Korean People's Democratic Republic shall serve to import the most advanced technological and scientific achievements for the improvement of the quality of products and the increase of exports.

(5) The joint ventures operating within the territory of the Korean People's Democratic Republic shall take the form of a limited liability company.

(6) The State protects, by the legislation in force, the resources invested by a foreign participant in a joint venture and the profits accruing in the normal course of business operations.

(7) The joint ventures shall conduct independent activities, based upon the laws of the Korean People's Democratic Republic, pursuant to the contracts concluded by the participants and the articles of association.

(8) All activities of a joint venture shall conform to the laws and regulations of the Korean People's Democratic Republic.

(9) Korean industrialists living in Japan and other compatriots overseas may also participate in such cooperative undertakings.

II. THE ESTABLISHMENT OF A JOINT VENTURE

(10) Foreign companies, firms and private entrepreneurs intending to produce cooperatively must conclude a business contract with a domestic company, in agreement with the Ministry of Foreign Trade, in advance.

(11) After signing a cooperation contract the contracting parties must apply *for approval* from the Ministry of Foreign Trade.

(12) The joint venture agreement must contain:
- the names of the contracting parties;
- the name of the joint venture;
- the duration of the joint venture;
- the amount of investment capital;
- the parties' shares;
- the structure of the board of directors;
- the number of employees;
- the salary of the employees;
- the expected working conditions;
- the insurance program; and
- any other factors of importance to the activities of the joint venture.

(13) The joint venture must be registered with the People's Committee in the district where the company is located. Upon registration the parties must submit, along with the certificate approving the cooperation agreement, the articles of association for the joint venture and a document verifying the capital investment. The joint venture exists as a legal entity from the minute of registration.

(14) If a joint venture wants to modify the materials submitted for registration, it must obtain approval

from the Ministry of Foreign Trade, after which it must inform the Bureau of Corporate Registration.

(15) The joint venture must have articles of association. The articles must contain the name of the company, the seat of local headquarters, the purpose of the company, the amount of investment capital, the shares held by the parties; the duration of the company, and all other items of importance.

III. INVESTMENT

(16) The joint venture determines the amount of capital and the shares of the parties, in accordance with the business agreement.

(17) The parties may invest money, buildings, raw materials, machinery and equipment, patent rights, technical documentation, the building site, etc., for use by the joint venture.

(18) The species of the currency invested is to be determined by the contracting parties.

(19) In the event buildings, raw materials, machinery and equipment, patent rights, or technological documents are used, their value will be determined in consideration of international market prices.

(20) In the event the site is not considered an invested asset, rent must be paid. The rent shall be determined by the National Price Office.

(21) The joint venture may not reduce its registered capital.

(22) The parties participating in the joint venture are liable for the debts incurred in the course of business in proportion to their contributions to the registered capital.

(23) If one party of the joint venture wants to grant a part or all of its capital to a third party, it must obtain the consent of the other party(ies).

IV. BOARD OF DIRECTORS AND MANAGEMENT

(24) The joint venture establishes a board of directors. The board of directors is the supreme organ for decision in the company.

(25) The board of directors consists of the appropriate number of members. The board of directors has a chairman and a vice-chairman. The number of directors on the board representing the contracting parties, and the choice of chairman and vice-chairman shall be set forth in the business agreement.

(26) The board of directors shall meet one or more times a year, as determined by the chairman. Acting under the authorization of the chairman, the vice-chairman may also call for a meeting of the board of directors. Prior to convening a meeting of the board of directors, the directors must be informed of the time, place and agenda of the meeting.

(27) The board of directors shall discuss and pass resolutions on the adoption of the articles of association, their modification and supplementation, the increase of investment capital, the extension of the duration of the company, the dissolution of the company, expansion projects and business programs, the settlement of accounts, the distribution of profits, the appointment of the chairman of the board and vice-chairman and their dismissal, the appointment of financial supervisors and other matters of importance arising in the course of business.

(28) Resolutions concerning the problems discussed by the board of directors must be passed by unanimous decision.

(29) The joint venture employs a president, a vice-president and the necessary staff of senior aides.

(30) The president of the joint venture organizes the economic activities in conformance with the business agreement which established the entity, the articles of association and the resolutions passed by the board. The activities of the president are subject to review by the board of directors.

V. PURCHASING OF MATERIALS AND SELLING OF PRODUCTS

(31) The joint venture should purchase the raw materials needed for production, semi-processed products and equipment, i.e., "materials", in the Korean People's Democratic Republic. The competent companies and government departments shall endeavor to ensure the delivery of materials ordered by the joint venture. The joint venture must purchase materials unavailable in the Korean People's Democratic Republic abroad.

(32) The joint venture may purchase patents on inventions, technical documentation, know-how, more sophisticated technology, etc., from other countries.

(33) The goods produced by the joint venture are intended mainly for export.

(34) The joint venture may arrange to purchase needed materials or sell produced goods in the Korean People's Democratic Republic, only through the competent trade organisation. The price is adjusted to the world market price. The joint venture may purchase a certain proportion of materials for its economic activities directly from the trade network.

(35) The joint venture may arrange the export of produced goods and the import of materials necessary for production, directly or through the trade organizations of the Korean People's Democratic Republic.

(36) The joint venture needs no import-export permit to import materials necessary for production or to export produced goods.

(37) The joint venture need not pay any customs duties when importing necessary materials for production.

(38) The joint venture must pay fees for the utilization of water, electricity, heating, telephone, etc.

(39) It is an important principle that the joint venture's property be insured.

VI. LABOR FORCE ECONOMICS AND MANAGEMENT

(40) The employment and dismissal of the domestic labor force by joint ventures is arranged through the Labor Office. The Labor Office must ensure the necessary labor force for the joint venture.

(41) The joint venture organizes the worktime, rest hours and labor protection of its employees according to the labor law of the Korean People's Democratic Republic.

(42) The joint venture may employ the citizens of other countries as well.

(43) The joint venture must increase the technological standard of the employees and give training to the skilled workers.

(44) The employees of the joint venture receive all benefits of the social security and social provision systems of the Korean People's Democratic Republic. The joint venture must pay a fee of 7% on the employees' payroll for social security, while the employee shall contribute an additional 1%.

VII.CURRENCY ECONOMICS/MANAGEMENT

(45) The joint venture maintains an account in foreign currency and in Korean currency at the Foreign Trade Bank of the Korean People's Democratic Republic or in another bank assigned by the Foreign Trade Bank. All income and expenditure of the joint venture goes through their currency account with the bank.

(46) The joint venture receives interest according to the official rate set by the Foreign Trade Bank on all deposits with the bank.

(47) The joint venture may open an account with the banks of other countries upon approval of the parties.

(48) When acting through a *foreign trade agency*, located in the Korean People's Democratic Republic, the joint venture must pay and receive foreign currency for all goods purchased and sold as well as any connected costs. All goods and services purchased directly through the domestic trade network will be paid for in Korean currency.

(49) In the event there is a shortage of operating capital, the joint venture may request financing in the form of loans from the banks of the Korean People's Democratic Republic or other countries.

(50) The settlement of accounts of the joint venture will occur mainly in Korean currency, but, with the consent of the parties, it may also occur in foreign currency. Income and expenditures of the joint venture will be converted into Korean currency at the rate of exchange determined by the Foreign Trade Bank.

(51) The joint venture shall determine the profit share to be remitted by the foreign party abroad. In the event of remittance to a foreign country, a document for control shall be submitted to the bank.

(52) A foreign employee working for the joint venture may transfer a maximum of 60% of his salary abroad.

VIII. SETTLEMENT OF ACCOUNTS AND DISTRIBUTIONS

(53) The joint venture must undertake a settlement of accounts every year. The fiscal year of the joint venture lasts from 1 January till 31 December.

(54) The settlement of accounts by the joint venture occurs by subtracting total prime costs from total annual income and arriving at the net income.

(55) The financial supervisor must control the annual accounts of the joint venture and must take responsibility for its precision before the committee.

(56) The financial supervisor may control the economic situation of the joint venture. The financial supervisor has access to the documentation, contracts and other materials of the joint venture which is necessary for the financial supervision.

(57) According to the joint venture tax law of the Korean People's Democratic Republic, the joint venture must pay profits tax from its net income.

(58) The joint venture must establish a reserve fund. The reserve fund is formed by the deduction of 5% of net income each year until the fund equals 25% of registered capital. The reserve fund is used for making up the deficit of the joint venture.

(59) The joint venture must establish funds to increase production and technological development, to provide an employee bonus and to supplement cultural events. The board of directors shall determine the types of funds to be formed and their magnitude.

(60) The distribution of profits to the parties of the joint venture occurs as follows:
- the profits tax is deducted from profits;
- the deduction for the reserve fund is also deducted from net profits;
- arriving at net profits, which is divided in proportion to the net share of each party.

The distributed profits may be reinvested.

IX. DISSOLUTION OF THE JOINT VENTURE

(61) The joint venture is dissolved on the date set forth in the business agreement for termination. In the event the joint venture is to continue activities after the termination date, 6 months prior to termination, the board of directors must approve the

decision, receive permission of the Ministry of Foreign Trade to continue and notify the Registry for Joint Ventures.

(62) The joint venture may be dissolved/liquidated before the deadline after a decision is taken by the board of directors in the following cases:
- if the joint venture operates with a loss for more than five continuous years;
- if one of the parties participating in the joint venture has neglected its obligations and serious damage has resulted;
- if due to uncontrollable circumstances the joint venture can no longer operate.

(63) To liquidate the joint venture, the council must appoint a liquidator, to whom the president hands over the business.

(64) The liquidator must report, prior to the commencement of liquidation procedures, to the Registry of Joint Ventures.

(65) After concluding the liquidation of the joint venture, the liquidator must distribute the remaining property among the parties in their respective proportion.

(66) The liquidator's actions are subject to review by the board of directors.

(67) After completing the liquidation, the liquidator must acquire the approval of the board of directors and report the completion to the Registry of Joint Ventures.

X. SETTLEMENT OF DISPUTED MATTERS

(68) Disagreements arising in the course of cooperation of the joint venture are settled by negotiation. If a disagreement cannot be settled by negotiation, it is turned over to a court of the Korean People's Democratic Republic or a commercial arbitration court to settle the dispute.

(69) The role of arbiter is fulfilled according to the articles of association or the rules of the commercial arbitration courts of the Korean People's Democratic Republic. The plaintiff and the defendant may appoint such person as arbiter as they prefer, even if he is not listed among the arbiters.

(70) The court operates according to the rules of civil procedure as set forth in the laws of the Korean People's Democratic Republic. The foreign party participating in the joint venture receives the same rights and protections under the law as the Korean party.

(71) Upon agreement by the parties, the negotiation of the disputed matter may be assigned to the commercial arbitration court of a third country.

TAIWAN:

An Outline of the Proposed Value Added Tax System

By Jap Kim Siong

INTRODUCTION

In an interview held recently in Taipei with the General Director of the Department of Taxation, Ministry of Finance of the Republic of China, Mr. Hsueh Chia-Chuen, it appeared that the introduction of a value added tax system in Taiwan is being seriously contemplated. The Draft legislation will be submitted at the end of 1985 or beginning of 1986 for approval by the Executive Yuan, and ratification by the Legislative Yuan is expected by early 1986. The likely date for implementation of the system will then be mid 1986.

The government has been considering introducing a VAT system for over 15 years with a view toward making revenue collection more efficient and toward streamlining the tax system.

The VAT will partly replace the current business tax, also called the gross business receipt tax, and will also replace the stamp duty payable on unified invoices and certain commodity taxes.

In Taiwan there is no general sales tax. Taiwan imposes only the business tax, which is in fact a turnover tax of the cascade type, and the commodity tax, a kind of excise tax.

If a taxpayer is subject to business tax, then he is not subject to the commodity tax and vice versa.

The key difference between the existing business tax and the VAT system is that business tax is levied on the total value of each transaction. VAT, on the other hand, is calculated only on the value added in the transaction.

At present, in the Asian-Pacific region, the countries levying a consumption type value added tax are: the People's Republic of China (1 October 1984), Indonesia (1 April 1985) and the Republic of Korea (1 July 1977).*

VAT TAXPAYERS

Article 2 of the Draft Act provides that VAT taxpayers shall be:
- those who sell goods or provide services;
- importers of goods, or holders of imported goods; and

* See Jap Kim Siong, *Taxation in the Asian-Pacific Region – A country-by-country survey.* 2nd revised edition. Asian-Pacific Tax and Investment Research Centre, Singapore, 1985.

- those paying for services performed in Taiwan by foreign enterprises as well as agents of foreign transportation companies with no permanent establishment in Taiwan.

BUSINESSES NOT SUBJECT TO VAT

The following businesses, which remain subject to the business tax, will not be charged VAT:
- banking, insurance, trust and investment securities brokers;
- bars, restaurants and entertainment businesses; and
- small-scale businesses.

Other businesses which pay a high commodity tax may remain subject to this tax and may thus be excluded from VAT in the initial stage to prevent a drop in tax revenue.

EXEMPTIONS AND ZERO-RATING

As is the case in most countries adopting a VAT system, the Taiwan authorities wish to eliminate VAT on the final sale of certain goods or services. This objective is achieved through a series of exemptions and zero-ratings. The crucial difference between the two is that the final seller of zero-rated goods can recover all VAT paid on purchases. Thus, the price paid by the purchaser of zero-rated goods will not reflect any VAT imposed in prior stages. By contrast, if the good is exempted, no credit for VAT previously paid can be claimed. A zero-rating is therefore more beneficial than an exemption.

The Draft Act proposes that the following sales of goods and services be zero-rated:
- exports;
- services relating to exports, services performed overseas or performed in Taiwan for use overseas, provided foreign exchange is earned;
- goods sold by tax-free shops;
- goods sold to enterprises within the Export Processing Zones and the science-based industrial park Hsinchu;
- international transport, provided reciprocal customs duty treatment is granted by the home country of the international transportation company;
- vessels, aircraft and deep sea fishing boats for international transportation; and
- sales of goods and services to vessels, aircraft and deep sea fishing boats used in international transportation.

Sales of goods and services that will be exempt from VAT include:
- sale of land;
- water used in farming;
- health services, medicine, lodging and meals provided by hospitals, clinics and sanatoriums;
- care-taking services, meals and lodging provided by kindergartens and sanatoriums;
- education services offered by schools, kindergartens and other educational and cultural institutions;
- authorized textbooks and officially supported academic writings issued by the publishing industry; and
- sale of meat on which slaughter tax has been paid.

Approximately 20 other categories of sales and services will also be exempted.

VAT RATE

The rate of VAT will not be lower than 5% nor higher than 10%. It is intended that, at the initial stage, a uniform rate of 5% will be applied. Transitional measures in the Draft legislation allow business tax, stamp duty and commodity tax, included in inventories at the time of implementation of the VAT system, to be credited against VAT subsequently paid.

COLLECTION PROCEDURES

Businesses within the VAT system will be obliged to issue uniform invoices to their customers. The new uniform invoices will be modified to show the sales amount and the VAT amount separately. Computer or machine generated uniform invoices will be permitted subject to case-by-case approval.

Each business will file a monthly return by the 15th of the following month, reporting sales and tax payable or refundable. Tax payable should have been paid before filing the return, which must be accompanied by a receipt. If the tax paid on purchases exceeds the tax paid on sales, the overpaid amount will be refunded in certain circumstances (i.e., if it results from investment in capital assets). Otherwise, the overpayment will be carried forward and offset against future VAT payable.

In addition, there are provisions in the Draft legislation for the authorities to carry out inspections and impose penalties. Various articles and books are circulating in Taiwan, at present, explaining the principles, nature and characteristics of the VAT system. The VAT will probably be called the Value Added Business Tax.

LATEST DEVELOPMENT

On 5 November 1985, the Legislative Yuan approved a completely revised Business Tax Law introducing a value added tax to be put into force on 1 March 1986 by Presidential Decree.

The text of the Revised Business Tax Bill was published for general information by the tax journal *Shuiwu* (Tax Affairs) No. 1228, at 29-34. Initially the tax rate will be fixed at 5% to prevent possible fluctuations of commodity prices. The new business tax rates for different categories of businesses under the VAT system, to be applied later, will be as follows:
- small-scale enterprises: 1%;
- profit-seeking enterprises, banking institutions, insurance companies, trusts and investment companies: 5%;
- clubs and restaurants with entertainment facilities: 15%; and
- restaurants, coffee shops and bars with special hostesses: 25%.

BANGLADESH:

Depreciation Allowances under the Income-tax Ordinance, 1984 – A Summary

By K.A. Gofran

Mr. K.A. Gofran, B.A., LL.B. is the Editor of *Bangladesh Tax Decisions* (a journal of tax cases).

1. The concept of depreciation in business

The term "depreciation" refers to the loss of value sustained by fixed assets such as buildings, plant and machinery, furniture and fixtures used by a business. In order to put the business on a sound financial basis, the loss must be estimated and charged against profits before arriving at net profit. Depreciation is essentially a cost of conducting a business and the total cost must include an allowance for depreciation if the profits or losses are to be shown accurately, throughout the use of the asset. For these reasons the concept of depreciation is important in modern business practice. By providing for depreciation, business firms are in a position to replace the fixed assets when these become obsolete. If no depreciation was charged against profit earned by use of these assets, fresh capital would then have to be raised for acquiring such assets. Charging depreciation dispenses with this necessity.

2. The tax laws of Bangladesh relating to depreciation allowances

The Bangladesh tax laws are adequate in the area of depreciation allowances. The allowances for depreciation cover all types of business and industry and ensure replacement or renewal in most cases. Under the repealed I.T. Act of 1922 depreciation was allowable in terms of sections 9A(2)(xiii), 10(2)(va), 10(2)(vi), 10(2)(via) and 10(2)(vib) read with Rules framed by the National Board of Revenue (NBR) prescribing the rate(s). Under the Income-tax Ordinance, 1984, which replaces the old Act, provisions have been made in the Ordinance for various depreciation allowances and these are contained in the Third Schedule to the Ordinance. The salient features of the provisions are discussed in the present article per item.

3. Depreciation allowance for agricultural equipment and works

Bangladesh, being a predominantly agricultural country with 56% of the nation's GDP coming from the agricultural sector, deemed it appropriate to provide, in the law, proper depreciation allowances on assets used for agricultural purposes when calculating income or profit from such a source. This allowance is specifically designed for irrigation or protective work. The following is the summary of the depreciation allowance for major items:

Classification of irrigation or protective[1] work or other capital assets	*Rate/percentage of the WDV (written down value) except as otherwise indicated*
1. "Pucca"[2] buildings	2½%
2. "Kutcha"[3] and "pucca" buildings	5%
3. "Kutcha" buildings	12½%
4. Temporary structures	—[4]
5. "Pucca" walls	2½%
6. Tube-wells	10%
7. Tanks	5%
8. "Pucca" irrigation channel	10%
9. "Kutcha" irrigation channel	20%
10. "Kutcha" irrigation wells	33½%
11. Tractors, oil engines and their implements	12½%
12. Power pumping machinery	12½%
13. Steam engines	5%
14. Workshop tools	10%
15. General machinery, not provided for above specifically	5%

4. Normal depreciation

A depreciation allowance is permissible in respect of buildings, machinery or plant, or furniture for the purpose of computing profits and gains from a business or profession. The law provides that a depreciation allowance will be proportionate to use, if the machinery or plant are not wholly used. It is further provided that the Deputy Commissioner may request information and documents to prove that the assets where used and determine whether or not the depreciation allowance is permitted.

This may be termed "normal allowance". The rate per item as per the Third Schedule is:

Class of assets	*Rate/percentage of WDV except as otherwise indicated*
1. Buildings (general)	10%
2. Factory buildings	20%
3. Furniture and fittings	10%

1. E.g. a protective wall for protecting paddy land.
2. "Pucca" = permanent.
3. "Kutcha" = temporary. Item 3 refers to buildings which have the characteristics of both types of buildings.
4. Renewal will be allowed as revenue expenditure (e.g. labor sheds or tea gardens).

Class of assets	*Rate/percentage of WDV except as otherwise indicated*
4. Machinery and plant:	
Special rates–	
(a) Ships:	
(i) Ocean-going ships (new)	10%
(ii) Ocean-going ships (second-hand), age at the time of purchase:[5]	
a) less than 10 years	10%
b) 10 years or more	20%
(iii) Inland ships including steamers, motor vessels, sails, tugboats, iron or steel flats for cargo, wooden cargo ships, motor launches and speed boats	20%
(b) Batteries, X-ray and electro-therapeutic apparatus and accessories thereto;	20%
(i) Machinery used in the production and exhibition of cinematographic films;	20%
(ii) Motor vehicles, all sorts	20%
(c) (i) Professional and reference books	30%
(ii) Aircraft, aero-engines and aerial photographic apparatus	30%
(iii) Moulds used in the manufacture of glass, plastic goods or concrete pipes	30%
(d) Mineral oil concerns–	
(i) Below ground installations	100%
(ii) Above ground installations, that is to say, portable boilers, drilling tools, well-head tanks and rigs	30%

The above rates of depreciation are subject to amendment by the NBR by notifications in the Official Gazette. Further, notwithstanding the rate prescribed, the NBR may, by notification in the Official Gazette, allow depreciation at such rate or rates as it may specify. Provision is also made for an extra depreciation allowance for plant and machinery used in double and triple shift working, subject to the approval of the Deputy Commissioner of Taxes regarding the claim. The requirements for normal depreciation must also be met for this allowance (extra shift allowance) to be applicable.

The provision relating to depreciation allowance stipulates that no depreciation is allowable for assets classified as "Machinery and plant" unless the normal useful life of the same exceeds one year, but in that case, cost of renewal or replacement is allowable as a revenue expenditure.

5. The allowance is to be calculated on the original cost.

5. Initial depreciation allowance

Provision is made for an initial depreciation allowance for newly erected buildings or newly installed machinery or plant in respect of the year of erection or installation or the year in which such building, machinery or plant is used, or the year in which commercial production is commenced, whichever is later. The rate prescribed is as follows:

(a) in the case of buildings	10% of the cost thereof to the assessee;
(b) in the case of machinery or plant, other than ships or motor vehicles not plying for hire	25% of the cost thereof to the assessee;
(c) in the case of ships whose port of registry is Bangladesh	30% of the cost thereof to the asessee.

The above depreciation is not permitted for any motor vehicle not plying for hire or for any machinery or machine which has previously been used in Bangladesh.

6. Accelerated depreciation

Bangladesh, being a developing country, urgently needs an industrial base for the production of essential consumer and capital goods and, therefore, the tax laws of Bangladesh must take into account these needs. With this end in view provision is made to allow accelerated depreciation in respect of machinery or plant (other than office equipment and road transport) which, not having been used in Bangladesh, has been or is used in an industrial undertaking set up in Bangladesh between 1 July 1977 and 30 June 1987 with the following rates of allowance:

(a) if the industrial undertaking is set up in areas specified by the Board for the year in which the undertaking starts commercial production	100% of the actual cost of the machinery or plant to the assessee;
(b) if the industrial undertaking is set up elsewhere than in the specified areas:	
(i) for the year in which the undertaking starts commercial production	80% of the actual cost of the machinery or plant to the assessee;
(ii) for the next following year	20% of the actual cost of the machinery or plant to the assessee.

The above depreciation allowance is subject to the condition that (a) the industrial undertaking is owned and managed by a Bangladesh company or a body corporate formed in pursuance of an Act of Parliament, (b) that it belongs to such class of industries as the NBR may specify by notification in the Official Gazette and (c) that the prescribed particulars have been furnished. Further, the application for allowance of this depreciation is required to be made within 4 months from the end of the month of commencement of commercial production and is to be accompanied by a declaration in writing that it is not a tax-holiday concern. No normal depreciation is admissible for an industrial undertaking qualifying for depreciation under this paragraph.

7. Special depreciation

Bangladesh, being a country situated in a deltaic region with a network of rivers and wanting to strengthen her merchant navy, provides a liberal depreciation allowance for ships and fishing trawlers. The law states that a passenger ship plying ordinarily on inland waters, or a fishing trawler registered in Bangladesh, which has been or is brought into Bangladesh for the first time on any day between 1 July 1982 and 30 June 1987, and is the property of the assessee, or a ship registered in Bangladesh, not being a ship ordinarily plying on inland waters, which has been or is used in Bangladesh for the first time on any day between 1 July 1982 and 30 June 1987 and is the property of the assessee, will qualify for depreciation at the following rates:

(i) for the 1st year – 40% of the original cost;
(ii) for the 2nd year – 30% of the original cost;
(iii)for the 3rd year – 30% of the original cost.

The above depreciation allowance is permitted if the ship in question conforms to such specifications, as the Government may set forth by notification in the Official Gazette, and if the prescribed particulars have been furnished. No other type of depreciation is admissible for any ship or fishing trawler which qualifies for this special depreciation.

The law relating to depreciation stipulates that the aggregate of depreciation allowances under the New Ordinance (I.T. Ordinance, 1984) or the I.T. Act, 1922, shall in no case exceed the original cost to the assessee and no allowance for depreciation shall be permitted in respect of the year of disposal of the assets. The law also provides for the computation of profits from the sale of these capital assets by determining the difference between the sale proceeds and the WDV or the loss from the sale of these assets as determined by deducting the expenditure from the profits in the year of disposal. It is also provided that unabsorbed depreciation, if any, is to be carried forward till it is entirely adjusted.

8. Concluding remarks

The new provisions relating to depreciation allowances for computation of profit from a business or profession are embodied in the relevant Schedule and are also clear and precise. The ambiguity of the older provisions no longer exists. The policy makers have made enough provisions both for the sake of fairness and practicability by taking into consideration modern technology and the changing economic needs of society. It can be said of the provisions that these are in conformity with the tax laws of other countries of the world and are progressive in nature.

Conference Diary

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

Seminar Services International: Holding and finance companies (including: Netherlands, Luxembourg, Netherlands Antilles, Channel Islands, Switzerland, Liechtenstein). Amsterdam (Netherlands), 6 and 7 March (English).

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).

Münchner Steuerfachtagung: Tax conference in Munich. Munich (German Federal Republic), 19 and 20 March (German).

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:

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.

Münchener Steuerfachtagung, c/o Prof. Dr. Klaus Vogel, Ludwigstrasse 28, Rückgeb., 8000 München 22, German Federal Republic.

Seminar Services International, Boulevard de Pérolles 7a, CH-1700 Fribourg, Switzerland.

The Zimbabwe 1985 Budget

By D.G. Murphy

Mr. Murphy is Lecturer in taxation at the University of Zimbabwe and tax consultant to Peat, Marwick, Mitchell & Co, Harare, Zimbabwe

The Minister of Finance and Economic Planning and Development, Dr. Bernard Chidzero, announced his proposed taxation measures to the House of Assembly on 30 July 1985. These measures were enacted in the Finance Act 1985 which was promulgated as Act No. 19 of 1985 on 30 October 1985.

Mr. Murphy's last article appeared in the July 1984 issue of the *Bulletin* (Vol. 38, No. 7) under the heading "The Zimbabwe 1983 Budget" which dealt with new legislation enacted up to 23 March 1984. In his current article he has taken the opportunity to interpose information as to changes announced in the 1984 Budget on 27 July 1984 and enacted in the Finance (No. 2) Act 1984, which was promulgated on 28 September 1984.

No new taxes were introduced in the 1985 Budget.

RATES OF INCOME TAX

Income tax comprises tax at basic rates of tax and surcharge.

No change was made to the rates of basic tax chargeable on taxable income, first introduced for 1978/79, which are as follows:

Companies – 45%

Other taxpayers –

Taxable income	*Basic income tax chargeable*		
	Family taxpayer		*Single taxpayer*
Z$	*Z$*	*Z$*	*Z$*
0 – 1,000	10%		14%
1,001 – 2,000	100 + 12% of excess over	1,000	140 + 16%
2,001 – 3,000	220 + 14% of excess over	2,000	300 + 18%
3,001 – 4,000	360 + 16% of excess over	3,000	480 + 20%
4,001 – 5,000	520 + 18% of excess over	4,000	680 + 22%
5,001 – 6,000	700 + 20% of excess over	5,000	900 + 24%
6,001 – 7,000	900 + 22% of excess over	6,000	1,140 + 26%
7,001 – 8,000	1,120 + 24% of excess over	7,000	1,400 + 28%
8,001 – 9,000	1,360 + 26% of excess over	8,000	1,680 + 30%
9,001 – 10,000	1,620 + 28% of excess over	9,000	1,980 + 32%
10,001 – 11,000	1,900 + 30% of excess over	10,000	2,300 + 34%
11,001 – 12,000	2,200 + 32% of excess over	11,000	2,640 + 36%
12,001 – 13,000	2,520 + 34% of excess over	12,000	3,000 + 38%
13,001 – 14,000	2,860 + 36% of excess over	13,000	3,380 + 40%
14,001 – 15,000	3,220 + 38% of excess over	14,000	3,780 + 42½%
15,001 – 16,000	3,600 + 40% of excess over	15,000	4,205 + 45%
16,001 – 17,000	4,000 + 42½% of excess over	16,000	4,655 + 45%
17,001 and over	4,425 + 45% of excess over	17,000	5,105 + 45%

Residents of Zimbabwe are taxable on foreign interest and dividends whether these are remitted to Zimbabwe or not. However, foreign dividends, other than those from building societies, are taxed differently in that they are taxed gross (i.e. without any deduction for the cost of earning them) and at the flat rate of 20% without the addition of any surcharge. Furthermore, they cannot be applied to reduce an assessed loss which the taxpayer may carry forward for set-off against future taxable income.

The tax chargeable on the taxable income at the rates set out above is reduced by the sum of the tax equivalent of the taxpayer's abatements – no abatement is allowable to a company – and in the case of a family taxpayer whose wife has earned income, the tax equivalent of the married woman's earnings allowance.[1] The reduced – unreduced in the case of a company – tax chargeable is subject to the following surcharge for the 1984/85 tax year –

Companies: 17½%

The effective rate of tax is therefore 52.875%. The surcharge for 1983/84 was 25% and thus there has been a reduction in company income tax for 1984/85 from the 1983/84 effective rate of 56.25%.

Foreign companies are subject to a further tax of 8.4% of their Zimbabwean taxable income. This rate is reduced to 2.5% in the case of a company resident and subject to tax in the U.K. which operates through a permanent establishment in the U.K. This further tax is Branch Profits Tax.

Under current legislation the 1985/86 rate of surcharge is 15% (giving an effective rate for income tax and surcharge of 51.75%). However, the trend in the past has been to review the rate of company tax for the statutory tax year to 31 March (for which a substituted accounting year may, with the approval of the Tax Department, be submitted) at the time of the Budget in the following August. The 1985/86 rate of company tax will therefore only become certain when the 1986 Budget is announced.

Individuals:

There are two separate surcharges for 1984/85. The first is a flat 2.5% and is referred to as the drought relief surcharge. This was first levied for 1984/85.

The second is levied on the following sliding scale –

Income tax chargeable	*Surcharge*		
Z$	*Z$*		*Z$*
0 – 4,000	15%		
4,001 – 5,000	600 + 16%	of excess over	4,000
5,001 – 6,000	760 + 17%	of excess over	5,000
6,001 – 7,000	930 + 18%	of excess over	6,000
7,001 – 8,000	1,110 + 20%	of excess over	7,000
8,001 – 9,000	1,310 + 22%	of excess over	8,000
9,001 – 10,000	1,530 + 24%	of excess over	9,000
10,001 – 11,000	1,770 + 27%	of excess over	10,000
11,001 – 12,000	2,040 + 30%	of excess over	11,000
Over 12,000	2,340 + 33.33%	of excess over	12,000

The maximum combined surcharge is therefore 35.83% and the top rate of income and surcharge is 61.125% for 1984/85. For 1983/84 the surcharge was levied as above, but the scale ran from 20% to 40% which gave a higher top rate of 63% for that year.

1. For further explanation see "Zimbabwe: A Survey of its Tax System" in 37 *Bulletin* (1983) at 28 and 29.

Under existing legislation the 1985/86 surcharges are identical to those for 1984/85. The existence of a PAYE system, which requires some certainty in tax rates from April 1985, makes it less likely that there will be a retroactive change to these 1985/86 rates than is the case with the company rate of tax.

CHANGES IN ABATEMENTS

The following increases were made to the abatements for 1985/86 and subsequent tax years:

Child abatement	– from Z$ 500 to Z$ 600 per child
Maxima for total of primary, child and dependant abatements	– family taxpayers from Z$ 6,000 to Z$ 6,600
	– other taxpayers from Z$ 3,600 to Z$ 3,800
Insurance abatement	– from Z$ 360 to Z$ 600

From 1986/87 the child abatement will cease to be available in respect of a child who turns 18, or more, during the tax year. Previously the age was 21. The reduction in the age from 21 to 18 is in line with the Legal Age of Majority Act which came into operation on 10 December 1982, but did not directly amend the income tax laws.

The following table shows income tax payable by individuals at selected levels of taxable income:

INCOME TAX PAYABLE (INCLUDING SURCHARGE)

	Single person		Married person with no children		Married person with two children		
Taxable income Z$	*1983/84 Z$*	*1984/85 + 1985/86 Z$*	*1983/84 Z$*	*1984/85 + 1985/86 Z$*	*1983/84 Z$*	*1984/85 Z$*	*1985/86 Z$*
4,000	494	484	192	188	NIL	NIL	NIL
12,000	3,278	3,210	2,592	2,538	2,400	2,350	2,308
20,000	7,462	7,305	6,516	6,381	6,321	6,190	6,147
32,000	14,464	14,093	13,412	13,075	13,198	12,868	12,822
40,000	19,492	18,969	18,411	17,920	18,187	17,703	17,654
50,000	25,792	25,082	24,711	24,033	24,487	23,816	23,767
60,000	32,092	31,194	31,011	30,145	30,787	29,928	29,879
70,000	38,392	37,307	37,311	36,258	37,087	36,041	35,992
80,000	44,692	43,419	43,611	42,370	43,387	42,153	42,104
90,000	50,992	49,532	49,911	48,483	49,687	48,266	48,217
100,000	57,292	55,644	56,211	54,595	55,987	54,378	54,329

(No reduction has been made for tax that may be applicable to the married woman's earnings allowance.)

OTHER INCOME TAX AMENDMENTS

(i) The legislation contains specific provisions to counter tax avoidance by effecting a diversion of taxable income to minor children. These provisions will cease to operate when the child turns 18 in 1986/87 (previously 21).

(ii) The single parent who was previously treated as a family taxpayer because he/she had custody of and partially maintained a lawful minor child may, from 1986/87, suffer the loss of the family taxpayer's abatement and of the family taxpayer's rates of tax at an earlier date due to the reduction made in the age of a minor child from 21 to 18.

(iii) The Finance (No. 2) Act 1984, promulgated on 28 September 1984 as Act No. 24 of 1984, introduced minimum statutory values in order to assess the taxable value of loans granted to employees interest-free or at low rates of interest and also introduced statutory rates of valuation in respect of the use of vehicles by employees. This Act specified 1 October 1984 as the date of operation in relation to loans in existence on or after this date. The date of operation of the new provisions concerning the use of vehicles was badly worded and has now been clarified as the first day of the 1984/85 tax year.

(iv) The deduction allowable for voluntary payments to retired employees and partners is reduced by any payments to the employee or partner from a pension or benefit fund to which the employer or partnership contributed in respect of the employee or partner. With effect from 1 April 1985 the deduction allowable will be reduced by any payment from a foreign, as well as a local, fund.

(v) The 15% investment allowance, on certain capital expenditure incurred for commercial or industrial operations in a specified growth-point area, has been extended to the end of the 1986/87 tax year.

(vi) Representation and entertainment allowances paid to full-time State employees were exempted from income tax.

(vii) Provincial governors have been placed on the same footing as Ministers and Deputy Ministers in relation to tax-free allowances.

WITHHOLDING TAXES

No changes were made in the 1985 Budget to the rates of the withholding taxes which remain as follows –

Resident shareholders' tax (RST)	20%
Non-resident shareholders' tax (NRST)	20%
Non-residents' tax on interest (NRTI)	10%
Non-residents' tax on fees (NRTF)	20%
Non-residents' tax on remittances (NRTR)	20%
Non-residents' tax on royalties (NRTROY)	20%

NRTROY was introduced with effect from 27 July 1984 by Act No. 24 of 1984 which was promulgated on 28 September 1984.

In terms of the double taxation agreement with the U.K., Zimbabwe's right to tax certain income is limited. The term "tax" is used here in the sense of all Zimbabwean taxes on income as set out in the agreement. The income must not be attributable to, or effectively connected with, a permanent establishment in Zimbabwe. The limitations imposed on Zimbabwean tax are that it shall not exceed: 5% of gross dividends received by a company which is resident in the U.K. and which controls directly or indirectly at least 25% of the voting power in the Zimbabwean company which paid the dividends; and 10% of the gross amount of interest, royalties or technical fees arising in Zimbabwe which are received by a resident of the U.K. It is also mentioned that, in terms of the agreement, the U.K. grants relief in respect of its tax on dividends from a Zimbabwean company for the underlying Zimbabwean company tax, as well as for the NRST, in the case of dividends received by a U.K. company which controls directly or indirectly at least 10% of the voting power in the Zimbabwean company which paid the dividends. As was pointed out in an earlier article[2] there is doubt whether NRTR is leviable in respect of the remittances of expenditure allocated by a U.K. enterprise to its Zimbabwean permanent establishment or by a U.K. resident to his/her fixed base in Zimbabwe. In the case of NRTF it must be remembered that the maximum of 10% referred to earlier applies to technical fees.

CAPITAL GAINS TAX

The rate of tax remains unchanged at 30%.

In Act No. 24 of 1984 exemption from tax was conferred on compensation paid by Government for its expropriation of externally quoted marketable securities held internally in the name of nominee companies as required by exchange control regulations.

However, in Act No. 19 of 1985 this exemption was restricted to holders of these expropriated securities who did not contest the amount of compensation paid under the regulations which authorized the expropriation. Taxpayers who contested the payment will therefore lose the benefit of the exemption, but any of these who realize a loss, instead of a capital gain, on the expropriation will gain the advantage of having the loss established for set-off against future capital gains; an advantage which is not available to those who remain unaffected by Act No. 19 of 1985.

Capital gains tax paid on the disposal by a taxpayer of chargeable assets has been made allowable as a credit against estate duty payable on the same assets in the estate of that taxpayer.

SALES TAX AND IMPORTS TAX

The rates of 18% on general goods and 23% on listed higher-rate goods effective on 1 August 1983 were reduced to 15% and 20%, respectively, on 27 July 1984 and no further changes were made to the rates.

On 27 July 1984 beers, most manufactured tobacco products and aerated non-alcoholic beverages were removed from all liability to these taxes with Government making up the loss of revenue by increased customs and excise duties on these goods.

With effect from 1 August 1985: registered operators may apply for permission to quote sales tax separately as a departure from the normal requirement to quote only the selling price, inclusive of sales tax; the figure of annual turnover at which a trader has to register was increased from Z$ 20,000 to Z$ 50,000; exemption was granted in respect of a number of orthopaedic and other appliances, including spectacles, false teeth and braille items, which compensate for a defect or disability; the procedure to protect a right of appeal was clarified; and a system for obtaining refunds of tax paid on goods of a capital nature acquired for use in specified growth point areas, by persons who carry on agricultural, hotel, industrial, manufacturing or mining operations, was introduced to encourage investment in these areas.

CUSTOMS AND EXCISE DUTIES

The increase on motor spirit from 55 to 62½ cents per litre made on 27 July 1984, which brought the pump price of blend to 103.8 cents per litre, was followed on 31 July 1985 by an increase of 3 cents in the duty on diesel fuel to 11.8 cents per litre, and on the same date computer spares and equipment became subject to duty based on 20%, ad valorem, with specially-equipped motor vehicles for the disabled becoming duty-free.

The 15% excise duty on vehicles locally assembled was cancelled on 27 July 1984 and on 31 July 1985 small increases were made in respect of items which included beer (1¢ per bottle) and cigarettes (1¢ per pack of 10).

On 31 July 1985 the customs duty-free allowance for passengers' baggage was increased from Z$ 100 to Z$ 150 per passenger with a further Z$ 50 of imports being allowed without the requirement of an import license.

MISCELLANEOUS

- On 27 July 1984 a tax of 20% became leviable on foreign currency made available locally for holidays taken externally and a withholding tax of 20% was imposed on royalties payable to non-residents;
- on 1 August 1984 company registration fees were increased to 16¢ per Z$ 100 of nominal capital, with a minimum of Z$ 50 for a private company and Z$ 200 for a public company, while other company fees rose by approximately 25%;
- also on 1 August 1984 the two rates of 7% and 5% previously used in calculating payments to encourage exports were collapsed into a single rate of 9%;
- on 1 October 1984 increases were made in the stamp duty leviable on chargeable items and a Z$ 10 airport departure tax was introduced;
- on 1 August 1985 the amount of foreign currency which could be purchased locally for external holidays was increased from Z$ 360 to Z$ 450 per annum;
- in his Budget speech on 30 July 1985 the Minister reassured married couples that the complaints of married women, who suffer income tax at the higher rates because of the aggregation of spouses' taxable incomes, were under consideration and were being viewed with the seriousness they deserved, but the Minister also said that only when the final recommendations of the Income Tax Commission – rumored as expected around June 1986 – were known would the full impact of the options available to Government be calculable.

2. "The Zimbabwe 1983 Budget", 38 *Bulletin* 7 at 305.

UNITED KINGDOM:

Exchange Rate Fluctuations

Memorandum submitted to the Inland Revenue in June 1985 in response to the invitation to comment on the Provisional Statement of Practice (SP 3/85 Provisional) "Exchange Rate Fluctuations" issued in January 1985.[1]

Contents

INTRODUCTION

Background

1. The House of Lords decision of December 1983 in the case of Pattison (Inspector of Taxes) v. Marine Midland Ltd. (Marine Midland) which was heard by the General Commissioners in 1978 relates to accounting periods going back to 1972, and illustrates the uncertainty which has existed for many years.

2. An Inland Revenue consultative document (Borrowing in Foreign Currency) was issued in October 1976 to which we (as a constituent member of the Consultative Committee of Accountancy Bodies) responded in December 1976 (published as TR 209).

3. We therefore welcome the issue of and the opportunity to comment on the Provisional Statement of Practice (the S/P), which goes some way towards clarifying the tax treatment of exchange rate fluctuations, a subject which has, because of its complexity and uncertainty, caused considerable concern to taxpayers and the Revenue alike.

Basis of comments

4. Our comments are set out under two main headings:
   (a) the general issues involved, and
   (b) the specific issues raised by the S/P.

GENERAL ISSUES INVOLVED

Background

5. We welcome the S/P as a practical step forward which should assist taxpayers to establish the taxation position on foreign currency translation adjustments, not only for the future but also in relation to assessments for past years which remain to be determined.

6. The S/P gives a general guide as to the basis for settlement but emphasizes that it may need to be modified in the way in which it is to be applied in particular circumstances. We look for reasonable flexibility from inspectors of taxes in reaching agreement in complex cases stretching over a long period of time.

7. The post war years have seen an enormous change in the status of sterling, including devaluation, the floating of currencies and the abolition of exchange controls. At the same time international trade and the raising of funds in foreign currencies have expanded. What was once a minor accounting matter has now become an area of considerable importance which is evidenced by the issue of SSAP 20 (Foreign currency translation) in April 1983 following exposure drafts in 1977 and 1980.

8. Financial transactions are now often very sophisticated and the matching of foreign currency positions, which can be effected in a variety of ways, may well be covered on a group basis, rather than within a single company.

9. The present proposals should, therefore, be seen against this background and should be developed with a view to achieving commercial reality in the tax treatment of profits and losses arising on exchange rate fluctuations. In particular we would favour convergence between accounts profits and taxable profits in the area of exchange differences.

Further issues

10. The S/P sets out general rules, and the principles which it establishes, including the examples given, deal with relatively straightforward situations. In practice the position is far more complicated, especially in the case of financial institutions. The examples relate only to two currencies, U.S. dollars and sterling, and assume that the application of funds borrowed to capital assets is readily identified. In practice borrowings may comprise a series of loans made in differing currencies and the related assets acquired may also be in various currencies.

11. There are a number of identification problems with the general rules in the S/P. The identification of liabilities in a currency with assets in the same currency may cause problems for the reasons set out above. Furthermore it is not clear what would constitute a currency liability or, more importantly, a currency asset.

12. A major problem which emerges from the S/P is the explicit desire to seek to maintain a rigid distinction between capital and revenue. In practice this distinction often cannot be made, especially with regard to borrowings where there is considerable uncertainty both to the taxpayer and the Revenue as to the tests to be applied in determining whether a borrowing is on revenue or capital account.

13. The need to distinguish between a capital and revenue borrowing is also difficult to justify in relation to exchange differences, which in some measure represent the differential in interest costs. The change introduced by Schedule 13, Finance Act 1969 overruling the decision in European Investment Trust Co. Ltd v. Jackson and recent changes in law (section 38, Finance Act 1980 and section 43, Finance Act 1984) to allow costs of obtaining loan finance rightly recognize the need to give relief for business costs and this principle should be applied to exchange differences on borrowings.

14. Thus we would favour a tax regime which effectively dealt with all exchange differences, regardless of their character, as being either within the charge to tax or as tax deductible. We recognize this as a major step but we believe it useful to raise the issue on which we consider there should be further consideration in due course having regard to the interaction with the chargeable gains regime including the impact of indexation.

15. Under present law and practice, for many taxpayers a distinction remains between revenue and capital in the foreign exchange area. In recent years, particularly for financial institutions, the Inland Revenue has been prepared to agree that funds may be "roundabouted" to achieve a matched revenue basis. We believe it important to know the Inland Revenue's views on this approach and would welcome confirmation that "roundabouts" may continue to be effective.

16. Clarification is needed as to how the S/P will apply to the taxation of foreign

1. Reproduced by kind permission of *The Institute of Chartered Accountants*. See for the text of the Provisional Statement of Practice SP 3/85 of 25 January 1985, 39 *Bulletin for international fiscal documentation* 8/9 (1985) at 383. See also the article by Jill C. Pagan, "U.K. Taxation and Currency Fluctuations", in the same issue at 379.

branches, especially where the branch books are kept in foreign currency and there are periodic remittances to Head Office. The profits of an overseas branch have been traditionally taxed either under the profit and loss or balance sheet method. Whilst in both cases the profit for the accounting period is determined by reference to the average rate of exchange, on the former basis no other adjustments are made, except as regards remittances; on the balance sheet basis, current assets and liabilities are translated at the year-end rates, the difference being included in the Case I computations, while fixed assets and capital liabilities are excluded. It is unclear as to how these methods are to apply in the context of the S/P.

17. Finally, under this general section, it is necessary, as indicated above, to recognize the range, number and complexity of transactions which give rise to exchange differences or to other differences, such as premiums and discounts on forward contracts, which are tantamount to exchange differences. The S/P makes no detailed reference to these areas and it will be essential that its development should have regard to their special characteristics.

Further consideration of the wider issues

18. We strongly support the statement in paragraph 1 of the S/P that the general rules may need modification. We have drawn attention above and in our detailed comments below to a number of issues which require further consideration and we trust that these matters will be the subject of further discussion.

SPECIFIC ISSUES RAISED

19. The following comments are made in relation to paragraphs 5 to 13 of the S/P.

Translation adjustments (paragraph 5)

20. We welcome the general approach to tax profits by reference to the accounts profits. Although the taxation of profits which are not yet realized is not strictly in accordance with case law, e.g. Willingale v. International Commercial Bank, the approach suggested will in practice avoid substantial problems of identification and is acceptable. However, where the principle established in Willingale is applied to the taxation of items giving rise to exchange differences, the taxpayer should have the option under the S/P to defer the taxation of the related exchange differences until realized, provided this basis is consistently applied.

Capital and current liabilities (paragraph 6)

21. The distinction between capital and current liabilities seems to dominate the theme of the S/P. As suggested earlier, this distinction is in most cases difficult to justify; indeed, it is especially difficult to do so in the context of financial institutions. Our comments in paragraph 12 above also apply here.

Matched assets and liabilities (paragraphs 7-9)

22. Where currency borrowings are matched with currency assets, there can be no commercial profits or losses and therefore any translation differences, whether reflected in the profit and loss account/reserves or not, should be completely ignored for tax purposes.

23. The definition of matching as proposed in paragraph 9 is appropriate only in certain simple situations. Matching can be effected in a number of ways, including forward purchase or sale of currencies. For instance, a financial institution may be regarded as matched in respect of a currency where the sum of assets in that currency plus any outstanding forward purchases equals the sum of liabilities and forward sales. The S/P definition of matching will need to be expanded to cover such cases.

24. Clarification is also required on such questions as to whether matching is to be by reference to an individual currency, a company or a U.K. group. The S/P assumes that the exercise of matching assets and liabilities is undertaken for an accounting period, and we suggest that further clarification is required as to the time in an accounting period when matching has to be achieved.

Assets and liabilities not matched (paragraphs 10-11)

25. The comments made in paragraphs 23 and 24 above also apply here.

26. Where there is an overall excess of currency liabilities over currency assets, an exchange difference adjustment to the accounts profit or loss should not be necessary for tax purposes unless the currency liabilities on capital account exceed the total currency assets; any adjustment should only be by reference to that excess.

Example:

At beginning of period, \$ 1.5 = £ 1

	£		£
Capital loan ($ 150,000)	100,000	Current assets ($ 150,000)	100,000
Overdraft ($ 300,000)	200,000	Cash	200,000
	300,000		300,000

At balance sheet date, \$ 1.25 = £ 1

	£		£
Capital loan ($ 150,000)	120,000	Current assets ($ 150,000)	120,000
Overdraft ($ 300,000)	240,000	Cash	200,000
		P & L – exchange difference	40,000
	360,000		360,000

27. The loss attributable to capital borrowing is £20,000 (£ 120,000 – £ 100,000). Under the S/P, the loss of £ 20,000 would be disallowed; however, the capital loan may in practice be matched with the currency assets and there would be no justification in disallowing any part of the loss of £ 40,000.

Assets held on the "realization" basis

28. Where a financial institution is taxed under the principle established in the Willingale case in respect of currency assets, the taxpayer should be given the option under the S/P to adjust the accounts for any translation differences in respect of these items so that any exchange differences are taxed only when the related assets are realized.

Capital gains (paragraph 13)

29. The decision in the case of Bentley v. Pike involved the inheritance of property situated in Germany in which it was held that the gains should be computed by reference to the sterling translation of the foreign currency at the rates ruling at the time of inheritance and at the time of sale respectively. It has little, if any, relevance to normal business transactions and application of such principles in a situation with matched currency assets and liabilities could result in double taxation or double relief for losses. It is hard to believe the current view of the courts would be to support such an illogical result.

30. Clearly the Marine Midland case does not deal with the problem arising from the decision in Bentley v. Pike. However, because the interaction of the proposals in the S/P for taxing exchange differences and the rule in Bentley v. Pike can result in taxing the same amount twice, it is suggested that the problem may be resolved by applying section 31, Capital Gains Tax Act 1979, under which any amount taxed as income is excluded from the consideration of the disposal.

EUROPEAN COMMUNITIES:

Financing the Community

In the July 1985 issue of the *Bulletin for International Fiscal Documentation*[1] two important documents of the Commission of the European Communities were reproduced on the replacement of financial contributions of the Member States by the Communities' own resources.[2]

On 21 October 1985 the Committee on Budgets published its report on the above documents.[3]

Finances are for the Community of crucial importance and this is the reason that the Report of the Committee on the Budget is reproduced in its entirety.

Contents

I. INTRODUCTION[4]

By letter of 15 May 1985 the President of the Council of the European Communities requested the European Parliament for an opinion on the proposal for a Council regulation (ECSC, EEC, EURATOM) extending 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.

On 10 June 1985 the President of the European Parliament referred this proposal to the Committee on Budgets as the committee responsible and to the Committee on Economic and Monetary Affairs and Industrial Policy for their opinions.

On 20 June 1985 the Committee on Budgets appointed Mr. P.A.M. Cornelissen rapporteur.

It considered the proposal and the draft report at its meetings of 18 September and 16 October 1985.

At the latter meeting the committee decided, with 13 votes in favour, to recommend to Parliament that it approve the Commission's proposal, subject to the following amendment.

The motion for a resolution as a whole was adopted with 11 votes in favour and three abstentions.

Present: Mr. Cot, chairman, Mr. Ryan, vice-chairman, Mr. Cornelissen, rapporteur, Mr. Abens, Mr. Bardong, Mrs. Fuillet, Mr. Fich, Mrs. Hoff, Mr. Mertens (deputizing for Mr. Pfennig), Mr. Langes, Mr. Louwes, Mr. Price (deputizing for Mr. Normanton), Mr. Scheiber (deputizing for Mr. Arndt), Mr. von der Vring, Mr. van der Waal (deputizing for Mr. Cicciomessere).

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The Committee on Economic and Monetary Affairs and Industrial Policy has decided not to deliver an opinion.

The opinion of the Committee on Budgetary Control is attached.

The report was tabled on 18 October 1985.

The deadline for tabling amendments to this report will be indicated in the draft agenda for the part-session at which it will be debated.

II. AMENDMENTS TO THE COMMISSION'S PROPOSAL[5]

The Committee on Budgets hereby submits to the European Parliament the following amendments and motions for a resolution together with explanatory statement:

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 bythe Communities' own resources (COM(85) 170 final – Doc. C 2-33/85)

6 *Amendments tabled by the Committee on Budgets*[6]

Preamble and recitals unchanged

Amendment No. 1[7]

Insert the following new article before Article 1

In Article 13(2) and (3), after:

no later than 30 days following the approval of this report of this report, the Commission shall adopt a decision which it shall communicate to the Member States

delete the text that follows, viz.:

and which shall apply after a period of 30 days if during this period no Member State has referred the matter to the Council.

The Council may, at the request of a Member State and acting by a qualified majority, revise the Commission's decision.

Articles 1 and 2 unchanged.

A. MOTION FOR A RESOLUTION

Embodying the opinion of the European Parliament on the

- proposal from the Commission of the European Parliament to the Council (Doc. C2-33/85 – COM(85) 170 final) for a regulation 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

  and

  on the 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

The European Parliament

- having regard to the Council Decision of 21 April 1970 on the replacement of financial contributions from Member States by the Communities' own resources,[8]
- having regard to the Council Decision of 11 May 1985 on the Communities' system of own resources,[9]
- having regard to the proposal from the Commission to the Council,[10]
- having been consulted by the Council (Doc. (2-33/85) COM(85) 170 final),
- having regard to the opinion delivered

1. At 315.
2. 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.
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.
3. Rapporteur Mr. Petrus A.M. Cornelissen, P.E. Document 126/85.
4. Heading added by the Editors.
5. Id. See also note 2.
6. A column titled "Text proposed by the Commission of European Communities" was printed in the original text. However, as there was no proposal reproduced it has been omitted.
7. There are no further amendments.
8. Official Journal of the European Communities (OJ) L 94, 28.4.1970, p.19.
9. OJ L 128/15, 14.5.1985.
10. OJ C 125, 22.5.1985, p.16.

by Parliament on the previous amendment and extension of Regulation No. 2892/77,[11]

- having regard to the report of the Committee on Budgets and the opinion of the Committee on Budgetary Control (Doc.),
- having regard to the outcome of the votes on the Commission proposal,

A. whereas improvements to the implementing regulations in respect of the own resources system are necessary, not least because of the increasing number of violations of the Community's financial autonomy in recent years,

B. whereas proposals for the revision of Regulation No. 2891/77 on own resources have been before the Council since 1982 and whereas Parliament has repeatedly urged that they be dealt with rapidly,

1. Takes note of the Commission's report on implementing Regulations No. 2891/77 and No. 2892/77 in respect of the Community's own resources system;
2. Regrets that a majority of Member States still record the Community's own resources in national budget documents as national revenue to be transferred subsequently to the Community;
3. Requests the Commission to take steps to induce the Member States that have not already done so to record the Community's own resources in national budgets and national accounts in a manner which is in conformity with the Community nature of these resources; considers that the Commission should devise a Community model on the basis of which the entries concerned could be harmonized;
4. Supports the Commission's preference for the returns method with regard to the calculation of the base for own resources accruing from VAT; reiterates that only a method based on the returns by taxable persons is compatible with the basic idea that the Community's own resources flow from European taxation rather than from national financial contributions;
5. Approves a further extension of Regulation No. 2892/77 in respect of own resources accruing from VAT until 31 December 1988; hopes, however, that the extension of Regulation 2892/77 will be used to encourage the Member States which have hitherto been using the statistical revenue method for the calculation of the VAT base henceforth to apply the returns method;
6. Requests the Commission to investigate ways of dealing with the genuine difficulties encountered in the Member States in applying the returns method;
7. Requests the Commission to develop and improve the returns method and, in so doing, to restrict to a minimum the additional administrative formalities which the returns method might entail, particularly for small businesses;
8. Believes that the revenue method must be corrected in order to prevent this method being, even temporarily, financially more advantageous for the Member States than the returns method;
9. Proposes in particular that the estimated assessments should be included more quickly in the calculation of the VAT base and that the information available to the Commission regarding the collection of VAT should be improved;
10. Reiterates its view that the management committee procedure under Article 13 of Regulation 2892/77 is at variance with the purely advisory powers of the Committee on Own Resources, particularly as each Member State has the option of having a Commission decision amended by the Council;
11. Requests the Commission, in the report it has promised to submit one year before the new own resources ceiling has been reached, to include a proposal that would permit a rapid transition to the returns method as the uniform method for establishing the VAT base;
12. Urges the Council to speed up its work with regard to:
    - the revision of Regulation 2891/77;
    - the 18th VAT Directive[12] concerning the gradual abolition of derogations from the common VAT system;
    - the Commission's proposals regarding measures to be taken in the event of irregularities which have consequences for own resources;
13. Draws the Council's attention in this connection to the amendment adopted by Parliament to the 1985 draft budget, pursuant to which 30 m ECU in revenue from interest on the Commission's own resources accounts with the national treasuries were included in the budget;
14. Is aware of the fact that such inclusion in the budget requires the amendment of Regulation 2891/77, pursuant to paragraph IV, 3(c) of the joint declaration of 30 June 1982,[13] reminds the Council however that pursuant to that same paragraph it is required "to use (its) best endeavours to adopt the regulation by the end of May at the latest";
15. Instructs its President to forward to the Council and Commission, as Parliament's opinion, the Commission's proposal as voted by Parliament and the corresponding resolution.

B. EXPLANATORY STATEMENT

Introduction

1. This Commission document (COM(85) 170 of 19.4.1985) is in two parts:
    - a report on the implementation of Regulations 2891/77 and 2892/77 which govern the system of own resources, and
    - a proposal to extend the term of validity of Regulation 2892/77, which is to expire on 31 December.

    This document is one of a serie of documents to the system of own resources which began in 1982.
2. The idea of own resources is closely linked to the very nature of the European Communities. The ECSC has had such resources since its inception, in the form of levies on the production of coal and steel. The High Authority of the ECSC was also empowered to contract loans (Article 49 ECSC).
    Unlike the ECSC, the EEC was initially financed by contributions from the Member States (Article 200 EEC). Article 201 EEC did however require the Commission to examine the conditions under which the financial contributions of Member States could be replaced by own resources, in particular by revenue accruing from the common customs tariff when it had been finally introduced.
3. This gave rise to the Decision of 21 April 1970[14] replacing the financial contributions from Member States by the Communities' own resources. This decision has just been replaced by the Decision of 7 May 1985[15] raising the maximum rate of mobilization of VAT to 1.4%, and allowing compensation to be paid to certain Member States by deduction from their VAT payments.
4. The Decision of 21 April 1970 was initially implemented by Regulation 2/71[16] of 2 January 1971. Following the 1975 Treaty widening Parliament's budgetary powers and the agreements on the basis of assessment for a common system of value added tax (6th VAT directive of 17 May 1977)[17] this regulation was replaced on 19 December 1977 by two new regulations:
    - Regulation 2891/77, laying down general provisions for own resources and specific provisions concerning the traditional own resources: customs duties, agricultural levies, and sugar levies;
    - Regulation 2892/77 dealing more specifically with own resources accruing from VAT.
5. Regulation 2892/77 left it up to the Member States to choose between two methods for determining the basis of assessment for VAT: the returns method and the revenue method, also known as the statistical method. The intention was to go over to a uniform system for collecting VAT resources by the end of 1982. Regulation 2892/77 was therefore scheduled to expire on 31.12.1982. Because of the delay in introducing VAT in the Member States, the Commission was unable to propose a uniform system in 1982. It did however propose changes in several other aspects of Regulations 2891 and 2892/77.

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11. OJ C 13, 17.1.1983, p.218.
12. See 25 *European Taxation* 5 (1985) at 140.
13. OJ C 194, 28.2.1982.
14. OJ L 94, 28.4.1970, p.19.
15. OJ L 128, 14.5.1985, p.15.
16. OJ L 3, 5.1.1971, p.1.
17. OJ L 145, 13.6.1977, p.1.

Consultation in the past

6. Parliament was therefore consulted on the following proposals:

A. Regarding Regulation 2891/77:

A1. COM(82) 316 of 20 July 1982 – OJ No. C 231, 4.9.1982. This proposal made a large number of technical improvements and amendments to bring Regulation 2891/77 into line with the proposals for amendment of the general Financial Regulation. There were also more fundamental matters such as independent powers of verification for the Commission and to enable Commission accounts with the national treasuries to bear interest.

A2. Following Parliament's opinion (Doc. 1-1006/82 – OJ No. C 13, 17.1.1983), the Commission tabled a *first amendment* to its proposal; COM(83) 254, of 10 May 1983 – OJ No. C 146, 4.6.1983. The Commission thus adopted Parliament's wishes as regards the bodies to which the Commission's accounts are open, the calculation of moratory interest, the rules for making own resources available in the absence of a budget, etc.

A3. In October 1983 the Commission introduced a *second amendment* to its initial proposal: COM(83) 621, 21.10.1983 – OJ No. C 303, 10.11.1983, adding to it a section which was still being considered in 1982 concerning the basic concept of establishing own resources.
This proposal was critically received by the Committee on Budgets. After it had been referred to that committee under Rule 36 of Parliament's Rules of Procedure, a text was drawn up as a compromise between the Commission and Parliament in respect of:
- the definition of the concept of "establishment" and the concept of own resources;
- the scop for delaying the making available of resources to the Commission or of waiving them;
- renewed progress towards harmonization of national provisions in respect of own resources.

A4. Parliament ratified this compromise text (Doc. OJ No. C 172, 2.7.1984), which was then adopted by the Commission in the *third amendment* to the proposal amending Regulation 2891/77: COM(84) 465, 31.7.1984 – OJ No. C 219, 21.8.1984.
None of these Commission proposals has yet resulted in a council regulation.

B. Regarding Regulation 2892/77:

B1. COM(82) 412, 9.7.1982 – OJ No. C 200, 4.8.1982, was the initial proposal to amend Regulation 2892/77 and was submitted at the same time as the initial proposal to amend Regulation 2891/77 (see A1 above).
In its opinion (Doc. 1-1006/83 – OJ No. C 13, 17.1.1983), Parliament largely supported the Commission's proposals, including the postponement of a decision on the definitive procedure for calculating the VAT base until June 1985. Parliament did however urge that the regulation include greater powers for the Commission in respect of corrections to the VAT base.

B2. The Commission adopted Parliament's opinion, except that part of it relating to the "management committee" on own resources, and submitted an amendment to its initial proposal, COM(83) 101, 1.3.1983 – OJ No. C 67, 12.3.1983.

B3. In the meantime, the Council had adopted Regulation 3350/82, 28.12.1982, OJ No. L 373, 31.12.1982, to extend the validity of Regulation 2892/77 until 31.12.1985.

B4. One year later, on 19 December 1983, the Council adopted Regulation 3635/83, OJ No. L 360, 23.12.1983, incorporating the main points of the other Commission proposals.

B5. The present proposal, COM(85) 170, will again extend Regulation 2892/77, until 31 December 1988.

The extension of Regulation 2892/77

7. In respect of Regulation 2892/77, which expires on 31 December 1985, the following questions are still outstanding:
- the definition of the *definitive system for establishing the VAT base* (see point 8 of this document)
- Parliament's amendment on the *powers of the Advisory Committee* on Own Resources, in particular to remove the Council's ability to overturn the decisions of the Commission at the request of a Member State (see points 9-20);
- abolishing the exemptions to the common system of VAT (see point 21);
- problems of control (see point 22).

8. Parliament's amendment on the *powers of the Advisory Committee* on Own Resources was based on constitutional arguments. By their very nature, the Communities' own resources can no longer fall under the control of the Member States, which makes it difficult to accept each Membe State's right to approach the Council to overturn a decision of the Commission.
An advisory committee holding powers of this nature is also an infringement of the division of powers between the institutions under the Treaties. The committee is in fact required to examine "problems arising out of application of this regulation", which is itself a regulation implementing the basic legislative decision. It is difficult to see how Article 155 of the EEC Treaty, which lays down the powers of the Commission, can be interpreted in such a way as to deprive it of the power of taking, on its own responsibility, measures to implementing a basic legislative act.

9. The *choice of the uniform and definitive method* for determining the basis of assessment for VAT resources gives rise to more complex problems.

10. The Commission originally proposed that the VAT base should be determined by reference to the returns made by taxable persons. Regulation 2892/77 described this as the "returns method". However, the Council established a second method, the "revenue" method, in which the VAT base is determined by dividing the total net revenue collected by an average weighted rate representing the VAT rates applying in the Member State concerned. The Member States could choose freely between the two methods until 31.12.1982, when a uniform and definitive method would be adopted.

11. Seven Member States opted for the revenue method from the start: Belgium, Germany, France, Italy, Luxembourg, the Netherlands and the United Kingdom. Greece has not yet introduced VAT. Denmark originally chose the returns method, but since 1983 has used the revenue method. At present, only Ireland is still using the returns method.

12. Despite claims to the contrary, the returns method does not require all taxable persons to show Community and national VAT separately on their invoices and returns. Nor does it require complicated calculations by those required to make the returns. The main difficulty in applying the returns method seems to lie in the models used in the national VAT systems for the periodic returns. Hitherto transactions have had to be broken down by VAT rate for SALES alone. The VAT paid on PURCHASES may generally be deducted as a whole item. For a correct application of the returns method PURCHASES must, according to the Commission, also be broken down per VAT rate. For both methods the national administrations are responsible for calculation and verification.

13. In the revenue method, calculation of the weighted average rate (by which the total revenue is divided to obtain the VAT base) is a complex operation involving various non-fiscal data. The advantage of this method, according to its supporters, was, when VAT was introduced, that use needed to be made only of figures already available to the various national authorities. This argument was largely disproved by the facts. The figures in the national accounts needed to analyse the total revenue by the VAT rates in force were not designed from a fiscal point of view and frequently show insufficient detail. Estimates from other sources therefore have to be made. These are complicated still further by differences between the national accounting systems of the Member States and by the fact that there is a considerable time lag between the period for which economic data are available and the financial year for which the VAT base is calculated. Since the estimated assessments are not incorporated into the VAT base until they are actually collected and not at the time of the levy itself it is distinctly possible that the revenue method could lead to an

under-assessment of the VAT base, i.e. deferment to the following year.

14. The commission has, moreover, not found any great differences between the two methods as regards the reliability of the final result of the calculations or their respective costs.

15. There thus remains only the fundamental political question:
    - Can Parliament tolerate the fact that revenue from VAT is being increasingly watered down to a national financial contribution following the necessary abandonment of the principle of the uniform VAT rate and can it accept that the establishment of the uniform VAT base is ultimately reduced to a statistical calculation?
    - Or must every effort be made in connection with the calculation of the VAT base to revive the Community's own resources system and the financial autonomy of the Community's which is dependent thereupon?

16. VAT, unlike the ECSC levy or the traditional own resources is not a Community tax. It is rather the first example of harmonized taxation at Community level. This harmonization is far from being complete, as the variety of rates applied in the Member States shows. Its yield goes largely into the national coffers.

17. Nevertheless, the Decisions of 21 April 1970 and 7 May 1985 make VAT part of the Community's own resources and distinguish between VAT resources and national contributions. It would therefore be desirable to assimilate the financial arrangements for VAT as far as possible to the other own resources and the provisions of the VAT directives, especially those of the Sixth directive on the uniform basis of assessment for VAT. Although the lack of harmonization in national VAT rates would make it difficult to collect Community VAT directly, it is necessary to ensure that the Community's budget does not become even more remote from its citizens.

18. The Commission still favours the returns method. Although there has been de facto harmonization in favour of the revenue method, the Commission is not proposing to make the latter the uniform and definitive method. The Commission prefers to extend the transitional period during which either method can be chosen. Barring any hope of a future upsurge of Community spirit among the national experts, this attitude does nothing to promote the returns method. The use of the revenue method has encouraged the national administrations, and the Commission, to develop a specific and complex system of calculations and estimates. If this system is allowed to continue and be extended, the chances for a readoption of the returns method will hardly improve.

19. In recent years the Community's own resources system has suffered a number of severe blows. The decision of 7 May 1985 not only strictly limited the increase in the VAT ceiling, it also introduced a graduation of the VAT rate, for certain Member States, in accordance with a method closely related to the idea of "juste retour". It is no longer exceptional for plans for Europe's further development to be based on intergovernmental rather than Community financing.
    If Parliament and the Commission are serious in calling for the Community's financial autonomy and the Community nature of own resources to be safeguarded, they must establish conditions encouraging the transition from the revenue method to the returns method.

20. For this purpose it is essential, firstly, that any possibility of under-estimation of the VAT base should be removed from the revenue method in order to avoid Member States giving preference to this method for financial reasons, even temporarily.
    Secondly, the returns method must also be further developed and improved, in particular in order to prevent an excessive administrative burden being placed on small businesses. At the same time the Commission's information system in respect of VAT must be improved in such a way that the data which are necessary for the application of the returns methods gradually become available. A first step in that direction has been made with the Commission's proposals regarding the measures to be taken in the event of irregularities which have consequences for own resources (see point 22 below). This first step should be followed by more specific proposals which will make it possible, when new own resources above the present 1.4% VAT ceiling are introduced, for a uniform returns method to be determined for the calculation of the VAT base.

21. In its opinion No. 2/85 of 3 July 1985 of the Court of Auditors was stated that the technical arguments put forward by the Commission in favour of extending Regulation 2892/77 were not convincing. The Court also points out that the continual existence of transitional arrangements over an excessively long period may also raise problems.
    However, for the reasons set out above, the rapporteur cannot endorse the Court of Auditors' conclusion that the definitive method must be established immediately.

22. Another major problem in respect of VAT is the number of possible *exemptions to the common VAT system*, which the sixth VAT directive permitted for a transitional period. The gradual abolition of many of these exemptions was the subject of a proposal for an eighteenth VAT directive of 4 December 1984.[18]

23. Finally, there is the problem of *checking the data forwarded by the Member States*. Article 12 of Regulation 2892/77 confines these checks to the correctness of the operations to centralize the assessment basis, to determine the weighted average rate and the total net VAT revenue collected. This article does not authorize checks on any fraud in individual returns; we would refer here to the Commission Proposal of March 1979 on the measures to be taken in the event of irregularities affecting own resources and the organization of an information system for the Commission in this field.[19] In February 1984 the Commission asked the Council to resume consideration of this proposal.[20]
    Pending the adoption of the proposed improvements, the Committee on Budgetary Control, in its opinion on this proposal (PE. 99.612), calls on the Commission to initiate an independent inquiry into VAT fraud.

24. The text of Articles 12 and 10b of Regulation 2892/77 which was amended by the Council in 1983 does not accord with the text proposed by Parliament. However, the present text of Article 10b enables the Commission, on correction of VAT summary accounts relating to previous years, to take the steps "it considers necessary to ensure the correct applicaton of this Regulation", even if the Member State does not agree. If the Commission assumes its responsibities in this respect, it would not seem necessary for Parliament to insist on a new amendment.

Current amendments to Regulation 2891/77

25. The Council is not showing much interest in pushing ahead with the amendment of this regulation. The Commission's initial proposals date back to 1982. They have been supplemented and improved in several subsequent amendment (see point 6). Two points in particular seem to be causing the Council difficulties, and both are related to the very essence of own resources:
    - the proposal to give the Commission independent powers of control (see point 2)
    - interest on Commission accounts with the national treasuries (see points 25 to 28).

    Parliament also urged the Commission to produce a paper showing how own resources are presented in the national budgets (see point 29).

26. On the first point, Parliament and its Committee on Budgetary Control in particular have on several occasions urged that the Commission be given greater control powers. The opinion of the Committee on Budgetary Control (PE 99.612) demands the early adoption of the amendments to Regulation 2891/77 to this effect proposed in September 1982.

27. On the second, the system set up under Article 9 of Regulation 2891/77 under

18. COM(84) 689, Doc. 2-1352/84.
19. OJ C 88, 4.4.1979, p.4.
20. Com(84) 54, 10.2.1984.

which own resources are entered in accounts with the national treasuries rather than being transferred direct to the Commission dates back to the time when the budget was financed from contributions by the Member States. Exchange rate risks were borne by the Member State. In those circumstances there could be no question of interest accruing to the Community.

28. With the introduction of own resources, the Commission had proposed retaining entry in accounts with the national treasuries, but in return, and in accordance with the principle of own resources, providing that it could freely use the amounts entered, which were no longer protected against exchange rate risks, but would yield interest.
The Council took up the Commission's proposal in that the Community now bears the exchange rate risk; however the sums do not bear interest and are available to the Commission only for its immediate financial needs. From this point of view, the Community is worse off under the own resources systems than it was under the previous system of national contributions.

29. Logically, in 1982 the Commission again pressed its previous proposal regarding interest. Nevertheless it abandoned its demand for free access to the sums due. Parliament fully supported this proposal. It also proposed that those Member States which so desired might credit the amount of own resources to an account with a financial institution in the Member State, so that the National Treasury would no longer have to bear the interest.

30. Parliament also used its budgetary powers to strengthen the Community nature of own resources along the lines proposed by the Commission.
In the 1984 budget, Parliament made a token entry for interest on revenue. In the 1985 budget, Parliament entered the sum of 30 m ECU against this item, as proposed by the Commission in its preliminary draft budget. In its initial proposals to amend Regulation 2891/77, the Commission estimated the total interest involved at 140 m ECU. This entry in the budget will force the Council to give its views on the Commission proposal, both on legal grounds as provided for in the Joint Declaration of 30 June 1982 (OJ No. C 194, 28.7.1982) and on grounds of balancing the budget, with a view to financing the 1985 budget.

31. Another point arising from the Community nature of own resources is *the way in which these resources are shown in the national budgets*. As the Community's own resources, they should not appear at all in national budgets and accounts. Annex II to the Commission report accompanying the proposal to extend Regulation 2892/77 describes the practice in each Member State.

32. This shows that in national *budget documents* only four Member States "have a method of presentation any where near in keeping with the nature of own resources" (para. 31, Commission report). They were Belgium, Germany, Luxembourg and the Netherlands. Although own resources are still mentioned in budget documents, there is no doubt as to their significance, which is for information only.

33. In Denmark and France, own resources are still included in national revenue and are then deducted in the form of "negative revenue" in the case of Denmark and "payments from State revenue to the European communities" in France. In the four other Member States, Greece, Ireland, Italy and the United Kingdom, the situation is even worse; they include own resources in the revenue side of their budgets before entering transfers to the Community budget on the expenditure side. Greece and the United Kingdom provide notes and tables "explaining all financial relations with the Communities" (last sentence of section A(1) of Annex II, Commission report).

34. In their *national accounts* eight Member States treat own resources in accordance with ESA (European System of integrated accounts) principles, which take into account the Community nature of own resources. Germany continues to ignore the ESA in this respect. Details for Greece are not yet available.

35. The Commission's conclusion that "this situation could be improved" (section 2.4. of the report) would seem to be rather an understatement. Fresh action by the Commission seems necessary, in order to compel the Member States that have not yet done so to record the Community's own resources in the national budgets and national accounts in a manner which is in conformity with the Community nature of these resources. It would also seem appropriate for the the Commission to draw up a Community model in order to harmonize the entries concerned.

III. OPINION OF THE COMMITTEE ON BUDGETARY CONTROL[21]

On 20 November 1984, the Committee on Budgetary Control appointed Mr. R. Ryan as member responsible for own resources.

The Committee considered and adopted the draft opinion at its meeting of 19 September 1985 by fourteen votes to three with one abstention.

The following took part in the vote:– Mr. Aigner, Chairman; Mrs. Boserup, vice-chairman; Mr. Battersby, vice-chairman; Mr. Ryan, draftsman; Mr. Alber (deputizing for Mrs. Lentz-Cornette); Mr. Anastassopoulos (deputizing for Mr. Marck); Mr. Dimitriadis, Mr. Früh (deputizing for Mr. Bardong); Mr. Guermeur; Mrs. Hoff; Mr. Papoutsis; Mr. Pitt; Mr. Price, Mr. Schön; Mr. Schreiber, Mrs. Scrivener; Mr. Simmonds and Mr. Tomlinson (deputizing for Mr. Wettig).

Introduction

1. The Committee on Budgetary Control attaches great importance to own resources and it is vital that all own resources which are due to the Community are collected and made available in full. In so far as possible, procedures for collection should be harmonized and frauds and irregularities which divert the Community's own resources should be eliminated.

2. It was for these reasons that the introduction to the discharge resolution for 1983[22] called attention to certain weaknesses in the own resources system and asked the Court of Auditors to prepare a special report on the customs duties and levies area of the own resources system.[23] The resolution also included a statement regretting the fact that there is no regular, obligatory transmission of information to the Commission on frauds and irregularities concerning own resources.

3. The Committee on Budgetary Control had already stressed this later point in the Gabert report; the resolution which accompanied this report was adopted by Parliament in April 1984.[24]

4. The Commission's report on the implementation of Regulations Nos. 2891/77 and 2892/77 concerning own resources is provided for by Article 22 of Regulation No. 2891/77.[25] Parliament requested this report in April 1982 in the context of the 1980 discharge resolution[26] and in April 1983 in the context of the 1981 discharge[27] resolution. Parliament also requested the report in resolutions of December 1982[28] and June 1984[29] on proposed amendments to the Regulations. Such a report is indispensable for Parliament which must, on the one hand, exercise its control over the proper functioning of the own resources system and, on the other, give its opinion on the regulations proposed in this area.

5. From the point of view of the Committee on Budgetary Control, the Commission's report gives a comprehensive review of the functioning of the own resources system. It is important to recall that the system chosen in 1979 to ensure the Community's financial autonomy, the aim of which was to cover all expenditure arising from Community activitity by resources determined and controlled by the Community, did not become completely operational until 1980 and had, by 1983, reached its limits. An appreciation of the functioning of the system must equally take into account the fact that, since 1983, the Community has been dependent on decisions taken by Member States for securing the resources it requires and that it is not yet clear when this state of affairs will come to an end.

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21. Rule 101 of the Rules of Procedure.
22. Draftsman Mr. Richie Ryan.
23. OJ C 122, 20.5.85, p.35.
24. OJ C 127, 14.5.84, p.52.
25. OJ L 336, 27.12.1977, p.7.
26. OJ L 46, 18.2.1983.
27. OJ L 174, 30.6.1983.
28. OJ C 13, 17.1.1983, p.218.
29. OJ C 172, 2.7.1984, p.145.

6. From the Budgetary Control viewpoint there are two broad areas to be considered. These are the control and functioning of the system and the identification and pursuit of frauds and irregularities.

CONTROL AND FUNCTIONING OF THE SYSTEM

Treatment of own resources in Member States' Budgets and National Accounts

7. In its resolution on proposed amendments to Regulations nos. 2891/77 and 2892/77 of 17 December 1982,[30] Parliament asked that a report be submitted on the treatment of own resources in national budgetary documents and accounts and on the compatibility of this treatment with Community's financial autonomy. As own resources have been allocated once and for all to the Community and control over these resources should be exercised by the Community's Budgetary Authority, they should not be entered in national budgets to receive national legislative authorisation . Nevertheless, as the Commission report makes clear, only four Member States present their budgets in such a way as to respect this principle. The failure of most Member States to recognise the logic of own resources in budgetary presentation is to be regretted, not least because the presentation adopted tends to suggest that own resources are a kind of national contribution to the Community's budget.
8. Although the Commission describes this situation in its report, it makes no proposals on how it might be improved. The Committee on Budgetary Control's view is that the Commission should make representations to the Member States concerned (Denmark, Greece, France, Ireland, Italy and the United Kingdom) in order to secure a more logical and coherent presentation of own resource in their budgets.
9. As regards national accounts, which are accounting and statistical documents and which show how own resources are considered by national administrations, all Member States, with the exception of Germany and, for the moment, Greece, treat own resources in accordance with Community rules. The Commission should make representation to the Member States concerned.

Establishment and making available of own resources

10. Article 1 of Regulation No. 2891/77[31] allows the establishment of own resources to be determined by reference to the national provisions of each Member State. This means that there is no common definition or harmonized application of the concept of establishment of own resources. To overcome this difficulty, Parliament and the Commission have proposed, in amendments to the Regulation still to be adopted by the Council, that the concept of establishment be clarified by reference to entry in accounts. Thus, own resources would be established with the entry into the accounts arising from the chargeable event. If entry into accounts is used to define establishment, a degree of harmonization which is lacking at the moment will be achieved.
11. Amendments proposed by the Commission and approved by Parliament specifying the conditions under which Member States may defer or be released from the obligation of making established entitlements available also await adoption by the Council. These amendments have been proposed because the concept of force majeure, notwithstanding Court of Justice rulings on its interpretation, continues to be applied in different ways by different Member States.
12. Until the concept of establishment is clarified by reference to entry in accounts and "force majeure" is replaced by a precise set of rules on when established entitlements need not be made available, the situation will remain unsatisfactory because own resources will not be defined and made available in the same way in all Member States. The Council should therefore be urged to adopt the appropriate legislation without further delay.

Control and correction of the VAT base

13. Control and correction of the VAT base hinges on the annual statement of tax – chargeable transactions submitted by Member States by 1 July of the year following the calendar year concerned. This forms the basis for corrections made to the VAT base including those arising from the control visits undertaken by the Commission in conjunction with the Member States. Current arrangements build into the system a delay in final establishment of the VAT base for any year and, in the event of unresolved disagreement between the Commission and a Member State, the Commission' s final recourse is invocation of Article 169 of the EEC treaty against the Member State. Difficulties in estimating the amounts involved make it more important that the Commission acts speedily to secure own resources which are not made available while disagreements are unresolved. In its annual report for the 1983 financial year[32] the Court of Auditors notes that the Commission has been tardy in initiating recovery action through the Court of Justice. Given the time lags which are in any case inherent in the control system this is to be regretted. The Commission should now examine all possibilities for earlier correction of the VAT base including correction before submission of the annual statement by Member States. For example, there may be possibilities for making corrections during the financial year concerned on the basis of the monthly statements of accounts forwarded by Member States.
14. Member States receive "compensations" for transactions which continue to be taxed although they should be exempt and "authorizations" for transactions which continue to be exempt although they should be taxed. These mechanisms have to be retained as long as the derogations in the sixth VAT Directive are retained. The Commission has suggested that most of these derogations be phased out in the period to 1 January 1988. Again, the proposal is still with the Council for decision and the Committee on Budgetary Control would ask that the Council be urged to accept the timetable proposed for the termination of these derogations.

Method for determining the VAT base

15. Regulation No. 2892/77 of December 1977[33] allowed Member States to choose between the returns method and the revenue method for determining the VAT assessment basis for a period subsequently extended by Regulation No. 3550/82[34] to the end of 1985. The returns method is based on tax returns while the revenue method applies the VAT rate or rates in force during the year to the total revenue collected. The returns method therefore establishes a direct link between the Community and the taxpayer whereas the revenue method is based on a statistical calculation using national data. The Commission now proposes an extension of the period of validity of Regulation No. 2892/77 on VAT to 31 December 1988. Notwithstanding the late implementation of Regulation No. 2892/77, the Committee on Budgetary Control deplores the fact that the Commission is not now in a position to recommend that the returns method be adopted in all Member States. In the Committee's view, the transitional period allowed to the end of 1985 should have been used by the Commission to encourage harmonization on the basis of the returns method which takes full account of the desirability of establishing a direct link between the taxpayer and the Community.
16. There is little evidence in the report that the Commission has, in fact, done this. Nor is there an explanation of why one Member State, Denmark, changed from the returns to the revenue method despite the fact that Article 3 of Regulation No. 2892/77 requires Member States to inform the Commission of underlying reasons for such a change.
17. In fact, only one Member State now uses the returns method, Ireland, and it is difficult to envisage the remaining Member States changing to it before the end of 1988 unless required to do so.

30. OJ C 13, 17.1.1983, p.21.
31. OJ C 336, 27.12.1977.
32. OJ C 348, 31.12.1984, p.27.
33. OJ L 336, 27.12.1977, p.9.
34. OJ L 373, 21.12.1982, p.1.

18. The view of the Committee on Budgetary Control is that the Commission should now bring forward a firm proposal for the adoption of the returns method and use any transitional period in order to ensure, in conjunction with Member States, that the returns method is properly implemented throughout the Community. Such a course of action would also give clear guidance to Spain and Portugal.

IDENTIFICATION, COMMUNICATION AND PURSUIT OF FRAUDS AND IRREGULARITIES

Inspection and control of "traditional" own resources

19. In accordance with Article 18 of Regulation No. 2891/77[35] Member States carry out verifications and enquiries concerning the establishment of own resources. Additional inspections are carried out with the Commission at the Commission's reasoned request. The Commission cannot carry out independent inspections nor can it control taxpayers directly. The joint inspections carried out, with the exception of those concerning sugar levies, are in effect inspections of administrations. The view of the Committee on Budgetary Control is that the Commission's powers of inspection in the area of own resources remain inadequate and that the Council should be urged to adopt without further delay the Commission's proposals for strengthening these powers including provision for independent inspection.

Communication of frauds and irregularities

20. It is a deplorable state of affairs that the Commission's information on frauds and irregularities is, as the report admits, "far from being as complete as it should be".[36] The report makes clear that there is no systematic procedure for the regular communication from Member States of frauds and irregularities concerning own resources. The Commission does not have information for detailed analysis of individual cases of frauds and irregularities and the implications of this go beyond the recovery of sums in the individual cases concerned. Without this information it is difficult to see how the Commission can become aware of loopholes in present procedures which may be exploited on more than one occasion or can bring forward proposals for closing these loopholes.

21. Moreover, without adequate information the Commission cannot estimate the sums lost to the Community through fraud in own resources or discuss with Member States their responsibilities for recovering or making good these losses. The Committee on Budgetary Control considers therefore that Regulations No. 2891/77 should be amended to require Member States to report on a regular basis all own resources frauds and irregularities involving sums over an agreed threshold in such a way as to permit analysis of these frauds, including analysis of their duplicability. The Commission's proposal for a Regulation establishing an information system in this field should be adopted by the Council without further delay. The proposal was submitted in March 1979.

Frauds and irregularities concerning VAT own resources

22. The Commission is considering whether it can investigate VAT frauds in Member States as requested by Parliament in the Gabert resolution[37] which was submitted by the Committee on Budgetary Control. The Gabert report considered that the information obtained could be used to revise the Community's share of the proceeds of VAT in each Member State. It is difficult to see how astute use of this information would undermine the fiscal nature of Community VAT as the Commission suggests in its report; the Committee on Budgetary Control would ask that Parliament calls upon the Commission to begin investigation of VAT frauds in Member States forthwith.

CONCLUSION

23. There is an approach to the question of own resources which, since 1980, has tended to raise doubts about the principle of financial autonomy by emphasising the "national contributions" aspect of certain own resources and, with increasing frequency, submitting the decision to raise resources to ratification by national authorities.

24. The extension of the period of validity of Regulation No. 2892/77 must not be an occasion for the consolidation of this development. Parliament can only accept this extension if, at the same time, measures to consolidate financial autonomy are taken.

The Committee on Budgetary Control therefore requests the Committee on Budgets to include the following paragraphs in the motion for a resolution on the Commission's report on the implementation of Council Regulations Nos. 2891/77 and 2892/77 concerning own resources and the Proposal for a Regulation extending the term of validity of Regulation No. 2892/77 concerning value added tax;

- Reiterates its preference for the returns method for determining the VAT base as the method which establishes a direct link between the Community and the tax payable and is most clearly compatible with the principle of the Community's financial autonomy;
- Urges the Commission to propose a Regulation which would require Member States to adopt the returns method over an appropriate period;
- Notes and deplores the fact that the practical application of the legislation establishing the own resources system, a system which did not become operational until 1980 and had reached its limits by 1983, has had the effect of making own resources increasingly resemble a form of national contribution to the Community's budget;
- Is deeply concerned that the tendency to treat and regard own resources as a form of national contribution is undermining the Community's financial autonomy which is a fundamental precondition of its existence;
- While noting that the erosion of financial autonomy is not solely due to methods of budgetary presentation deplores the inclusion, in some Member States, of own resources in budgetary documents ratified by national authorities and calls upon the Commission to urge those Member States whose budgetary presentation and accounting procedures do not respect the Community nature of own resources to change their presentation accordingly;
- Deplores the fact that frauds and irregularities concerning the Community's own resources are inadequate;
- Insists that frauds and irregularities affecting own resources are uncovered and pursued and calls upon the Council to adopt the proposed amendments to Regulation No. 2891/77 which would allow the Commission to carry out independent inspections of irregularities affecting traditional own resources;
- Deplores the fact that the Commission does not receive regular and comprehensive information on own resources, frauds and irregularities from Member States and calls upon the Council to adopt without further delay the Commission's proposed regulation for Member States to report frauds and irregularities on a regulare basis;
- Calls upon the Commission to begin independent investigation and analysis of VAT frauds;
- In view of the importance of the subject requests that a conciliation procedure between Parliament and the Council be opened.

35. OJ L 336, 27.12.1977, p.8.
36. COM(85) 170 final. p.11.
37. OJ C 127, 14.5.1984, p.53.

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Contents

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A Survey of Taxes on the Individual in Ghana*

An emerging principle of modern income taxation is that the individual should be taxed on the basis of his ability to pay. The difficulty, however, is to design a tax system that reflects the individual's ability, particularly in less developed nations where there are wide gaps between rich and poor. A wealth tax, an estate tax, a succession tax, or a capital gains tax can be a useful supplement to the income tax in aiding to define the individual's ability to pay.

In Ghana, a capital gains tax, a donations tax, a wealth tax, and an estate tax have all been employed, at one time, in addition to the income taxes payable by the individual. However, the estate tax was repealed in 1969 and the wealth tax, which was introduced in 1984, has since been suspended.

Currently, in Ghana, the most important form of direct taxation on the individual is the income tax levied in terms of the provisions of the Income Tax Decree 1975 (as amended). Generally, residents are taxed on income accruing in, derived from, brought into or received in Ghana; non-residents, only to the extent that the income is derived from Ghana. Income includes gains or profits from any business, trade or profession, royalties, interest, dividends, annuities, and any gains or profits from employment including any allowances or non-cash benefits. With respect to benefits in kind, the employee's taxable income is increased, according to tables in the Income Tax Decree, where he has the use of a motor vehicle, accommodation or furnishings provided by the employer. These increases are, in effect, nominal, but are intended to reflect, in some measure, the gain derived by the taxpayer from such non-cash benefits.

Exemptions from taxable income include: wound and disability pensions; severance pay; a rent allowance of not more than 20% of the employee's basic annual salary; income from scholarships or similar educational endowments; any benefits received under social security legislation; interest by a non-resident on Government bonds and bonds of a registered co-operative society or statutory corporation; and investment income of an approved pension or provident society or fund.

In the determination of taxable income, any expenditure which is wholly, exclusively and necessarily incurred in the production of the income, except expenditure of a capital nature, is deductible from gross income. Bad and doubtful debts are specifically deductible, but income tax, profits tax or other similar taxes charged within or outside Ghana, travel expenses between an individual's residence and place of business, and any sums recoverable under an insurance or indemnity contract are, among others, specifically disallowed. No general provision for the set-off and carry forward of losses exists in the Income Tax Decree.

The rates of personal taxation are graduated into 16 rate brackets from 1% on the first 1,000 cedis to the top rate of 60% on the comparatively low amount of 30,600 ¢ (see Table 1). Provisions exist in the legislation for marginal relief and a number of personal reliefs are available to individuals (e.g., 5,000 ¢ for a married man, 3,600 ¢ for a single person and an additional 2,000 ¢ for individuals with yearly income under 12,000 ¢). Relief is also given, in the form of a deduction, for contributions made or premiums paid in respect of life insurance, pensions and social security. The aggregate amount of reliefs for life insurance, pension and social security contributions may not exceed 4,000 ¢.

Dividends, interest, royalties, and fees are considered part of taxable income. Tax is withheld at source on payments of dividends by Ghanaian companies to individuals, resident or non-resident, at a rate of 30%. Interest payable to resident individuals is liable to deduction at source at a rate of 30%. Interest and royalties payable to non-resident individuals are liable to tax deduction at source at the appropriate individual rate of tax provided that the amount of tax payable by the non-resident individual is not less than 35% of his total income derived from Ghana. Although not specified in the legislation, any taxes so withheld at source are considered a prepayment of tax and set off against the taxpayer's final tax liability. Foreign dividends, interest, and royalties payable to residents are included in taxable income. No credit is available for foreign tax paid on the income, however, unless provided for by a double taxation agreement.

Income by way of rent is computed and taxed separately from other income under the Rent Tax Law 1984 and, in the case of non-residents, the tax is with-

Table 1
Individual income tax

Individuals are subject to tax at the following rates:

Taxable income (¢)		Rate of tax
First	1,000	1 %
next	1,000	1.5%
next	1,000	2.5%
next	1,000	4 %
next	1,000	7.5%
next	1,000	10 %
next	1,000	15 %
next	1,200	20 %
next	1,200	25 %
next	1,800	30 %
next	1,800	35 %
next	2,400	40 %
next	2,400	45 %
next	3,000	50 %
next	4,800	55 %
next	30,600	60 %

* This note was written by Ms. Beatrice Sergiovanni and Prof. John Mills with the assistance of the staff of the International Bureau of Fiscal Documentation.

held at source, again, provided that the amount of tax payable by the non-resident individual is not less than 35% of his total income derived from Ghana. A taxpayer with no other source of income is granted an exemption of the first 3,000 ¢ of rental income. In addition, an allowance of 30% is deductible from gross rental income. Rental income is taxed at rates varying from 5% on the first 480 ¢ to 60% on amounts received over 13,500 ¢.

A capital gains tax was introduced in Ghana by the Capital Gains Tax Decree 1975. Capital gains accruing to a taxpayer from the disposal of chargeable assets are computed separately from other income and taxed at rates that vary from 15% to 55%, according to the length of the period of ownership (see Table 2).

Table 2
Capital gains tax

Period of ownership	*Rate of tax*
up to 5 years	55%
5 – 10 years	45%
10 – 15 years	35%
15 – 20 years	25%
over 20 years	15%

Chargeable assets are defined as buildings of a permanent or temporary nature, business assets including goodwill, land, and any right or interest in stocks and shares. There are no exemptions provided for in the legislation. However, the capital gains realized on the sale of a dwelling house are not taxable if they are used to acquire another dwelling house within 1 year of the disposal and the taxpayer does not dispose of the dwelling house so acquired within 5 years. The amount of gain is calculated as the proceeds realized from the disposal (in cash or in kind) less allowable deductions and annual depreciation at specified rates (e.g., 7.5% for furniture, fixtures and fittings, 3% for land). Deductions are allowed for the acquisition cost of the asset, expenses incidental to the sale of the asset, and expenditures incurred on alterations and improvement of the asset by the person disposing of the asset.

No death duties are c urrently levied in Ghana since the estate tax was repealed by the Estate Duty Act

Table 3
Gift tax

Value of gift (¢)	*Rate of tax*
0 – 2,000	Nil
2,001 – 4,000	5 %
4,001 – 10,000	7.5%
10,001 – 20,000	10 %
20,001 – 50,000	12.5%
over 50,000	15 %

(Repeal) Decree in 1969. Under the Gifts Tax Decree 1975, a tax is levied on all transfers of assets by way of inter vivos gift. The gift tax applies to the transfer of land, buildings, stocks, bonds and other securities, and money. Gifts made by one spouse to the other, by a parent to child or child to parent, and for charitable or educational purposes are exempt from tax. Gifts which have a value of less than 2,000 ¢ are also exempt. The gift tax is levied on the market value of the asset at the time the gift was made at the rates shown in Table 3. Where a donee receives more than one gift in any tax year, and the value of each gift exceeds 2,000 ¢, tax at the appropriate rate is levied on the aggregate value of all gifts received. If the value of any gift does not exceed 2,000 ¢, tax may nevertheless be payable if the aggregate value of gifts received by the donee over any period of 5 consecutive tax years is more than 2,000 ¢.

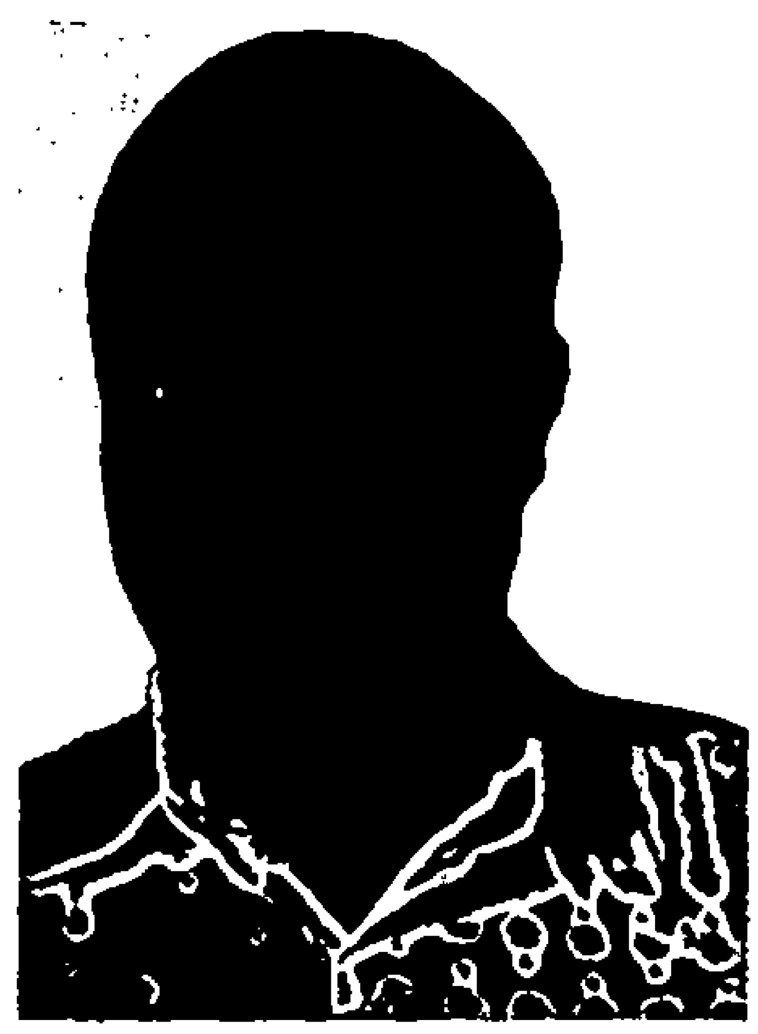
Because of the absence of estate and succession taxes in Ghana and the limited scope of the gift tax, a wealth tax was viewed as an alternate means to assess the individual on the basis of his ability to pay and to effect a redistribution of wealth. In Ghana, as in other developing nations, the benefits to be derived from the imposition of a wealth tax can be limited. Since these nations have been seriously crippled by the high rates of inflation of the last decade, a wealth tax may create more problems than it could be expected to solve. The timing of the imposition of the law, as well as its scope, are important factors to be considered before a wealth tax is introduced.

In the following article, the author presents some of the issues to be considered before the wealth tax, as it is presently formulated, is reintroduced in Ghana.

Ghana's Wealth Tax

Some Issues and Problems

By J.E.A. Mills



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A law imposing a tax on net wealth was passed by the government of the Provisional National Defence Council on 15 September 1984 for the first time in Ghana's history.[1] Since then many views have been expressed concerning the desirability of such a tax in Ghana. This debate, which has reportedly forced the government to take the unprecedented step of temporarily suspending the tax, should continue for some time and this article, which examines some legal and non-legal issues likely to arise from the implementation of the tax, will hopefully contribute to this debate.

SUMMARY OF THE WEALTH TAX

The wealth tax is to be imposed annually on the net wealth of any individual, computed on the basis of the value of any and all assets specified in the first schedule to the law, owned by that individual as determined on the valuation date.[2]

The specified chargeable assets are:

(i) buildings;
(ii) undeveloped urban building plots;
(iii) uncultivated arable land lying within five kilometers radius of any trunk road or all-weather feeder roads;
(iv) motor vehicles other than commercial vehicles; and
(v) pleasure boats, yachts and personal or private aircraft.[3]

Not all assets falling within the above-mentioned categories are, however, taxed. The following assets are specifically exempted:

(a) stool property;
(b) one owner-occupied dwelling house, the assessed value of which does not exceed 500,000 cedis; and
(c) a farm building, situated on a farm, which is used to provide accommodation for farm workers, storage for farm produce or shelter for livestock.[4]

The tax is not imposed on "gross wealth", but rather on "net wealth" which is to be ascertained by deducting from the value of the chargeable asset "any debt owed on that date and which has been incurred by the taxpayer, for the purpose of acquiring, maintaining or improving the value of such asset".[5] The tax rates[6] range from 0.25% on net wealth exceeding 500,000 cedis (90 cedis = $ 1), but not exceeding 1,000,000 cedis, to a maximum of 5% on net wealth exceeding 5,000,000 cedis. Net wealth, which in any year of assessment does not exceed 500,000 cedis, attracts no tax.[7]

WHY A WEALTH TAX?

The introduction of a wealth tax at this point in Ghana's history is hardly surprising. Indeed, many economists strongly believe that one of the principal reasons (if not the main one) for the slow pace of economic development in many developing nations is their inability or failure to impose the right taxes.[8] The imposition of a wealth tax is one of the measures recommended. The arguments in favor of such a tax appear so convincing that many developing nations searching for appropriate means of accelerating their rates of economic growth find the adoption of the tax

1. Wealth Tax Law, 1984, P.N.D.C.L. 93. Even though the law exists on the statute books, there are unofficial reports that the implementation of the law has been temporarily suspended to enable the appropriate authorities to take a second look at it. These reports, unconfirmed as they are, might very well be true because, to the best of the writer's knowledge, no such tax has been levied on any taxpayer since the law was passed. The suspension of a tax, albeit temporary, is unprecedented in Ghana's modern history.
2. Id., S.1(1).
3. Id., first schedule.
4. Id., S.4.
5. Id., S.3(1).
6. Id., second schedule.
7. Id., S.1(2).
8. See, for example, Nicholas Kaldor "Will under-developed countries learn to tax?" *Essays on Economic Policy* (London, Gerald Duckworth & Co. Ltd, 1964) Vol. 1, 255-265; Reproduced in, *Readings on Taxation in Developing Countries*: Richard M. Bird and Oliver Oldman eds. 3rd ed. (The Johns Hopkins University Press, Baltimore and London), 29-37. See also J.F. Due "Taxation and Economic Development in Tropical Africa" (The M.I.T. Press, Cambridge Mass. 1963, 161-164).

irresistible. Ghana is not the first, nor will it be the last developing nation to adopt this tax.[9] In the absence of any memorandum on the Wealth Tax Law giving the aims and objectives of the Law it is difficult to determine which specific considerations motivated the government to adopt the tax. Nevertheless it can be safely assumed that the Ghanaian government must have been influenced by the advantages that are associated with this tax. Though the advantages differ from country to country,[10] they generally include the following:

- the tax helps to achieve equity in taxation by providing a more realistic definition of taxable capacity;
- it helps to achieve certain desired economic effects;
- it enhances efficiency in income tax administration; and
- it provides revenue.

A. Evaluation of Ghana's tax

Having stated the main advantages generally derived from the imposition of the tax, I now propose to evaluate Ghana's tax in light of these advantages and to determine the extent to which the wealth tax can help achieve these.

(i) Tax equity

Equity is an important objective of taxation. An income tax by itself, the advocates of the wealth tax argue, is incapable of achieving tax equity. Not only is income considered to be an inappropriate yardstick for determining a person's taxable capacity, but also by taxing income, as opposed to capital, income tax discriminates against those who are yet to accumulate wealth. Moreover, income tax is said to impose a heavier tax burden on the holders of high-yield securities and risky investments which produce income regularly, than on holders of low yield or no yield investments. A wealth tax, on the other hand, is based on a person's total wealth which is the proper measure of taxable capacity and does not suffer from the abovementioned defects of the income tax. Consequently, as a supplement to the income tax, the wealth tax may help to remove the inequalities in the income tax system.

Does Ghana's tax, as presently formulated, help to achieve tax equity? A critical examination of the tax base suggests that the achievement of equity was perhaps not one of the reasons behind the adoption of the tax, because the tax base is too narrow and selective. Firstly, excluded from the tax base are such forms of wealth as cash, gold, diamonds, jewelry, bonds, shares and the like. However, in view of serious problems of discovery and identification of these forms of wealth, as experienced in countries such as Japan,[11] it is not difficult to appreciate why, in choosing the tax base, the equity principle was sacrificed in favor of practicality. The fact still remains that the tax imposes a heavy burden on owners of chargeable assets, while persons with similar taxable capacity are left untouched for the sole reason that their wealth is in a form which normally gives rise to problems of identification and discovery. Apart from the obvious inequity inherent in the system, the exclusion of these items will tend to discourage investment in chargeable assets and encourage the conversion of wealth into such items as cash, gold, jewelry, etc. This trend, if unchecked, may eventually lead to a further erosion of the tax base.

Secondly, also excluded from the tax base are commercial vehicles.[12] This may be for the following two reasons: (a) to encourage investments in public transportation and (b) the owners of such vehicles already bear their fair share of the existing tax burden in the form of income taxes on their profits from the operation of these vehicles and, therefore, there is no need to impose an additional burden. If either or both of these conditions led to the exclusion, then it is arguable that real estate should also have been excluded. In the first place, as indicated under Ghana's recently enacted Investment Code, real estate development is one of the priority areas of investment for which special incentives are to be provided.[13] Furthermore, the owners of real estate also bear their fair share of the tax burden in the form of property taxes, capital gains taxes and income taxes on rental income derived from their buildings, whether domestic or industrial.

However, there are exemptions which are understandable and defensible on grounds of equity, e.g. the exemption of stool property from the tax. The reason

9. India and Ceylon (now Sri Lanka) adopted the tax, reportedly on the recommendation of Nicholas Kaldor. See Nicholas Kaldor, *Indian Tax Reform*, Department of Economic Affairs (New Delhi) 1956, 19-28, and *Suggestions for a Comprehensive Reform of Direct Taxation*, Government of Ceylon (Colombo, 1960) 13-14. The Santiago Conference on fiscal policy for economic growth in Latin America held in Santiago, Chile in December, 1962 also recommended the introduction of the tax. See "Report of the Conference" issued by the Joint Tax Program of the Organization of American States, Inter American Development Bank and Economic Commission for Latin America (Baltimore, 1965), 421. Even among developed nations, the attraction of the tax appears to be equally strong. In a survey conducted in 1976 by the O.E.C.D., of the 21 countries which responded to the questionnaire 10 had a net wealth tax while 11 did not. Those who had the tax at the time were: Austria, Denmark, Finland, Germany, Ireland, Sweden, Luxembourg, the Netherlands, Norway and Switzerland. See "The Taxation of Net Wealth, Capital Transfers and Capital Gains of Individuals" Report of the O.E.C.D. Committee on Fiscal Affairs (Paris, 1979), 25.

10. See O.E.C.D. Report, op. cit., 25-26.
See also, Noboru Tanabe "Taxation of Net Wealth" International Monetary Fund. Staff Papers, XIV (March, 1967), 124-125, 142-156, reproduced in Bird & Oldman eds., op. cit., 256-270.

11. One of the main reasons for the repeal of the tax in Japan was reportedly the sharp imbalance of its burden, between those who owned cash, jewelry, bank deposits and the like – which were very difficult for authorities to trace – and those with real property that was relatively easy to identify. Other reasons which accounted for the repeal of the law were:
(1) The valuation of assets and liabilities presented difficulties for the tax administration.
(2) The tax produced only a small part of total revenue, compared with its costly administration.
(3) Although the tax aimed at encouraging wealth to shift to more productive uses, the result was quite beyond that expected, because such a shift required so many considerations in addition to the form of taxation, and the tax was adopted under unsatisfactory conditions for investment after the war. See, Noboru Tanabe, op. cit., 260-261.

12. P.N.D.C.L., 93, first schedule.

13. See Investment Code, 1985, S. 12(1).

is that stool property does not belong to any particular individual. It belongs to the whole clan, family or village and the chief or occupant of the stool is only a trustee or caretaker of the communal property. Consequently, since the tax is imposed on the wealth of the individual it stands to reason that no individual can be made to pay a wealth tax on stool property. Also reasonable, but perhaps not justifiable on equity grounds, is the exclusion of farm buildings from the tax base. However, given the nature of the type of farm buildings exempted one can appreciate the need and justification for sacrificing tax equity in order to encourage investment in agriculture, which is, above all, one of the priority areas of the economy.[14]

(ii) Economic effects[15]

It cannot be denied that there are certain desired economic effects that the tax will help to achieve. One is that it can produce a shift in the behaviour of taxpayers and thereby stimulate the desired economic activity. The imposition of the tax and the need to avoid payment of the tax are factors which are likely to force the owners of such assets to put them to productive use. In Ghana's case, it could be argued that the owner of uncultivated arable land might be forced to cultivate it in order to be able to pay the tax. Another desired economic effect of the tax is that, since it is imposed on the total sum accumulated by the taxpayer regardless of the extent of the income or gain derived from it (unlike the income tax, which levies its toll on realized gains and profits), it is unlikely to constitute a disincentive for hard work. Further, while the inclusion of undeveloped urban buildings plots will have the desired economic effect of discouraging land speculation in the urban areas, it will also create hardships for two classes of urban plot owners, many of whom are allottees of government plots who are clearly liable to the tax. These are:

(a) the many owners of partially developed urban plots who have been forced by the ever-rising costs of building materials to abandon the development of their plots; and
(b) owners of urban plots who have not even started developing their plots because they lack the resources to do so.

To such owners, who are clearly non-speculators, the tax poses a serious dilemma. So long as their plots remain undeveloped or partially developed, they will be forced to use what little resources they possess, which they could otherwise have accumulated to develop their plots, to pay the wealth tax. What is worse, their plots, when eventually developed, might attract an even heavier tax! Certain undesirable economic effects may result from the tax. The first of these is the possible conversion of expenditures from durables and real estate development to non-durables and investment in such non-chargeable assets as cash, gold jewelry and the like. This development would certainly defeat one of the main objectives of the Investment Code, i.e. the encouragement of investments in real estate development. The second economic disadvantage is that the tax may be shifted, especially when the burden is considered heavy. It is not impossible to imagine owners of buildings, for example, shifting the tax burden to their tenants.[16] While this is not a unique result, the net effect would be that the tax would be effectively borne by a class altogether different from that for which it was meant.

(iii) Administrative efficiency

The widely held view that the existence of a wealth tax enhances efficiency in income tax administration by providing information, which can be used for cross-checking and thereby help to detect inconsistencies, is questionable. As Tanabe[17] explains, "an examination of a man's property ownership (if disclosed) usually leads to the discovery of concealed income just as an examination of his income receipts (if disclosed) leads to the discovery of conceivable property". The existence of a tax on both property and income, he concludes, "should improve the administrative efficiency of the system and provide a better check on evasion and concealment than a tax on either alone."[18] While it is true that certain countries[19] have found that the introduction of the wealth tax has enhanced efficiency in their income tax administration, it should be observed that it is not the mere imposition of the tax which promotes efficiency. As the Santiago conference recognized, in 1962, this benefit can only be obtained where there is already in existence a highly efficient income tax administration. If the existing administration is inefficient or weak, the introduction of the tax can only create more administrative problems. It is no wonder that the conference resolved that "introduction of this tax in the near future may be advisable only in countries possessing these administrative prerequisites".[20]

Two questions need to be posed here. First, does Ghana currently have a highly efficient income tax administration? And second, if it does, to what extent will the tax enhance efficiency in the existing income tax administration? It would be dishonest to answer the first question in the affirmative. That all developing nations, including Ghana, are yet to attain an optimum level of efficiency in income tax administration is one common finding of studies undertaken in this area.[21] Given the usual constraints of lack of proper

14. Id., S.12(1).
15. For a fuller discussion, see, Richard Goode, *The Individual Income Tax* (The Brookings Institution, Washington, 1964), 13.
16. It may be argued that as far as "domestic" buildings are concerned, this is unlikely to happen since rents are currently controlled under the Rent laws. However, it is also well known that most landlords find the "controlled" rents unrealistic in view of present day costs and have been agitating for either a revision of rents or the repeal of the law. Whatever the case, it is clear that the government cannot control rents indefinitely and that when the "lid" is taken off, one can only expect an escalation in rents, which will be partly due to the effect of the wealth tax.
17. Noboru Tanabe, op. cit., 264-265.
18. Id., p. 265.
19. See, O.E.C.D. Report, op. cit., 121-128.
20. See, N. Tanabe, op. cit., 266.
21. See, Milton C. Taylor "The Relationship between Income Tax Administration and Income Tax Policy in Nigeria", *Nigerian Journal of Economic and Social Studies* 9 (July 1967) 203-15 reproduced in Bird & Oldman op. cit., 528-540. See also, Stanley S. Surrey, Tax Administration in Underdeveloped Countries, University of Miami Law Review XII 158-188, (1958), reproduced in Bird & Oldman, op. cit., 479-499.

and adequate personnel and resources, the present income tax administration can be said to be only reasonably efficient. It follows, therefore, that Ghana cannot expect any dramatic improvement in income tax administration through the imposition of a wealth tax. Since the present level of income tax administration is reasonable at best, the tax will only succeed in helping to create more administrative problems. Even where there exists an efficient income tax administration, one author has warned that the possibilities of such administrative improvement are limited and cannot be attained without considerable effort and costs.[22] The type of information that the introduction of the wealth tax is to help provide can easily be gathered, given the uncomplicated nature of Ghana's current income tax system, without the aid of a wealth tax. The following observation by Surrey, while it underscores the points so far made, should also serve as both a lesson and a warning.

> Much of tax policy is being directed to obtaining increased revenues to enable governments to carry out their economic planning. The search is for additional taxes, for new sources of revenue. Yet it is true in many countries that the successful administration of some of the existing taxes would provide a considerable part of the needed additional revenue. The diligent execution of existing taxes may well make unnecessary, or at least reduce, the multiplication of taxes in search of revenue. It should be noted that this multiplication of taxes can, through a dispersion of administrative resources, result in a weakening of the entire tax structure. Moreover, the adoption of new taxes to compensate for the failure to enforce existing taxes may distort the equity of the system, for soon the rationale of the structure is lost in a complex maze of one set of taxes imposed to adjust for the defect in another set.[23]

(iv) Revenue yield

Even though most advocates of the tax would readily concede that a high revenue yield is not one of its main attractions[24], this is perhaps the greatest advantage that Ghana can expect from the tax. As is explained later, thanks to a combination of such factors as the method of valuation of assets, the assets chargeable, and the effect of almost a decade of serious inflation immediately preceding the introduction of the tax, there is the potential for a high revenue yield. However, as we have argued elsewhere, while government will find such high revenue yields most welcome, it is likely to bring in its wake dissatisfaction, and create problems of payment.

B. Other issues and problems

Apart from those identified in the foregoing discussion, there are certain issues which make the introduction of a wealth tax in Ghana, at this point in its history, undesirable. These generally relate to the determination of the tax chargeable, valuation of assets and payment of the tax.

(i) Determination of the tax chargeable

As already indicated, the tax is not levied on "gross" wealth but on "net wealth" of any individual "computed on the basis of the value of any or all of the assets" (as specified in the first schedule) owned by that individual as determined on the valuation date.[25] The law then goes on to explain that, in levying the tax "there shall be deducted from the value or the aggregate value of any or all of the assets specified in the first schedule to this law owned by him on the valuation date, any debt owed on that date and which has been incurred by him for the purpose of acquiring, maintaining or improving the value of such asset."[26] Thus, there are three main conditions which must be satisfied before a debt can be deducted. First, it must be seen to be a debt; second, the debt must have been outstanding on the valuation date; and finally, the debt must have been incurred for the purpose of either acquiring, maintaining or improving the value of such asset. While the second and third conditions should not present many problems of legal interpretation, the same cannot be said for the first condition. Even though the whole provision on deductibility seems to revolve around the word "debt", the law unfortunately fails to provide us with any definition. The only guidance offered under the Law is in the form of a caveat that, in defining the word, "no account shall be taken of the amount of any tax or penalty chargeable under this law, the Income Tax Decree, 1975 (S.M.C.D.5) The Rent Tax Law, 1984 (PN.D.C.L. 82) or any rates, charges or tax imposed on property by any local government authority."[27]

The word debt does not lend itself to easy interpretation. It appears to encompass a number of transactions. This is evident from Webster's New Twentieth Century Dictionary which defines it as either "an obligation or liability to pay or return something" or "that which is due from one person to another or others whether goods, money or services, or something owed."

A statutory definition would have helped to throw light on this dark corner of the law and also clearly indicated its exact parameters. As things are, the responsibility of offering guidance on the exact scope of the word seems to have been placed on the courts and the Revenue Commissioners, and their task will be an onerous one.

Even apart from this problem of interpretation, there are other undesirable effects from the implementation of the provision. The first is that taxpayers may feel encouraged, if not compelled, to borrow rather than use their own resources or to re-invest the income generated from their assets to acquire, maintain or improve chargeable assets, even when they have the resources to do so. Even if the financial institutions would be in a position to meet the demand for such facilities, it is doubted that in this period of Ghana's economic reconstruction, borrowing or lending for the

22. Noboru Tanabe, op. cit., 265.
23. Stanley S. Surrey, op. cit., 480.
24. See, O.E.C.D. Report, op. cit., 21-24.
25. P.N.D.C.L., 93 S.1(1).
26. Id., S.3(1).
27. Id., S.3(2).

acquisition, maintenance or improvement of such assets as non-commercial motor cars, pleasure boats, yachts and personal aircraft is the type of economic activity that should be encouraged.

Another possible effect of the provision is the discouragement of wealthy taxpayers from settling their debts or at least slowing down repayments as the valuation date, the 1st of January, draws near.[28] It may, however, be argued that this practice can be checked through the imposition of default charges by financial institutions and other lending agencies on defaulting debtors. While this measure would ensure that the creditor does not lose through debt defaults, there is still the question of how such situations are to be considered for the purposes of the tax.

(ii) Valuation of assets

Two problems that can complicate the implementation of the tax relate to:

(a) the question of what particular assets should be taken into consideration in computing the tax; and
(b) the actual valuation of the assets.

(a) *Assets to be valued for wealth tax*

Since the tax is to be based on the "value of any or all of assets owned by that individual as determined on the valuation date,"[29] the law would appear to encourage taxpayers to employ such avoidance devices as would enable them to legally dispose of such assets before the valuation date, but at the same time retain *de facto* control over and derive every possible benefit from the asset. This particular problem seems to have been expertly solved through the adoption of two specific anti-avoidance provisions aimed at countering the effect of such dispositions. The first such provision is Section 6(1) which disregards, for tax purposes, any transfer of an asset that is not made for valuable consideration. The second is a provision which empowers the tax authorities to disregard, for tax purposes, any transfer made to:
(a) an infant;
(b) a voluntary or charitable organization that is not absolute and vested in and controlled by its trustees;
(c) a company wholly owned by the taxpayer; and
(d) a company the shares of which are jointly owned by the taxpayer and a member of his family.[30]

(b) *Actual valuation of assets*

One problem that is likely to arise and thereby give cause for considerable dissatisfaction among taxpayers, lowering taxpayer morale, and consequently affecting compliance with the tax, is the troublesome one of actual valuation of assets. There appear to be two main options available in this area: first, the current market value; and second, the book value. However, the book value approach is considered unrealistic[31] and consequently many countries, like Ghana,[32] have adopted the market value option. The adoption of this option requires that assets be valued annually or, at least, periodically.[33] Considering the number of chargeable assets which need to be valued and also the fact that the tax is a national one, such official valuations are bound to be time-consuming and expensive. This is one problem that Ghana must deal with and it is doubted whether she has the requisite administrative machinery and the resources to undertake such periodic official valuations. The adoption of the self-assessment system under the law can only minimize, but not completely, remove the need for the periodic official valuations. It is true that under this system, which has also been adopted in the Netherlands and Ireland,[34] the primary responsibility for asset valuation is that of the taxpayer. The taxpayer is expected to forward his figure, which is then subject to review and, if necessary, challenged by the tax authorities. However, since the value given by the taxpayer is not final and may be subject to challenge by the tax authorities,[35] there would still be the need for official valuations if this cross-checking is to be done effec-

28. The foregoing discussion is not meant to suggest that the allowance of debts as a "deductible" expenditure is unique to Ghana's tax law. On the contrary, it appears to be a common feature of many wealth tax laws. But in many such countries the scope of debts is much wider and a premium does not appear to be placed on whether or not the debt was outstanding on the valuation date.
See, O.E.C.D. Report, op. cit., 34-35.
29. P.N.D.C.L., 93 S.1(1).
30. Id., S.6(2).
31. This approach, which was rejected, was recommended by Kaldor to the Government of India. The importance of this method is that all assets would be valued at cost and they would continue to be so valued (subject to depreciation) until the assets passed out of the account through sale, gift or bequest. The asset would, therefore, have to be valued (1) when the tax is initially introduced, and (2) subsequently, only when the property was transferred to a different owner other than through sale. This approach is, however, criticized by Goode as follows: "If items are assessed at book value or original cost until a transaction occurred. . . the wealth tax would lose much of its advantage as a supplementary measure of economic capacity. Failure to take account of unrealized appreciation or decreases in the value of assets would be a more serious defect in a wealth tax than in an income tax. Any particular gain or loss affects wealth in all subsequent years, but it affects income of only one year; hence later actual or constructive realization will do more to make up for the earlier omission of accrued gains and losses under the income tax than under the wealth tax. A wealth tax on book value, like a tax on realized income, imposes an additional liability when appreciated assets are sold and may defer economically, desirable switches of investments.
See, Richard Goode, op. cit., 32, and also, Tanabe, op. cit., 267.
32. Section 5 of P.N.D.C.L., 93 provides as follows:
"The value of any asset for the purposes of this Law shall –
(a) in the case of land without building, be the current market value;
(b) in the case of land with building, be the replacement cost or current market value whichever is higher;
(c) in any other case, be the cost or current market value whichever is higher."
33. In countries with the wealth tax, three main procedures have been adopted. The first is that the value of the taxpayer's total net wealth, as fixed for a particular year may be treated as remaining unchanged for a number of years. Secondly, the values of particular classes of assets (especially real estate) may be fixed by an official valuation which then remains in force at the same figure for several years. Thirdly, set rules or formulae for valuation of particular classes may be laid down. While most countries reassess the taxpayer's total wealth every year, there are differences. In Denmark, the official valuation of immovable property remains in force for 4 years; Sweden for 5 years; Germany it is revalued every 6 years; and Austria revalues every 9 years.
Fur a fuller discussion, see, O.E.C.D. Report, op. cit., 48-49.
34. Id., 49-55.
35. P.N.D.C.L., 93 S.(9).

tively. While the adoption of a self-enforcing device,[36] as advocated by Kaldor and Strasma,[37] and the rigorous enforcement of the penalty provisions under the law would check under-valuation by taxpayers, these measures will not completely obviate the need for comprehensive, official valuation records. A much more serious problem is the high property values that may be assessed. As has been very well documented in various I.M.F. and World Bank reports on Ghana, and also evidenced by the massive devaluation of the cedi from an exchange rate of 1.15 cedi to the dollar in 1976 to 60 cedis to the dollar as of 8 October 1985. Ghana has been ravaged by serious inflation over the past decade or so, with the result that values of properties acquired prior to and during this period have risen dramatically. In spite of continuing efforts to control inflation and reduce prices to realistic levels, they still remain extremely high. It is no exaggeration to say that a modest three bedroom house acquired at a cost of about 100,000 cedis between 1974 and 1979 would be currently valued at not less than 2.5 million cedis. The current high cost of building materials, which is in itself a reflection of the current high property values, has, as already indicated, contributed to the abandonment of partially developed plots, scattered all over the urban areas. The wealth tax, coming at the end of this long period of inflation, and based as it is on the current market values of assets, can only be expected to impose a heavy burden on all taxpayers affected by it. Given current real estate values, the benefit that the taxpayer is expected to derive from the exemption from the tax of "one owner-occupied dwelling house, the assessed value of which does not exceed five hundred thousand cedis"[38] is likely to be more illusory than real. The resultant high wealth taxes are bound to create dissatisfaction, lower taxpayer morale and lead to serious problems of payment. Since the tax is based neither on realized capital gain nor income, but on unrealized "capital gain", the taxpayer who has property, but little or no current income, might be forced to either borrow to settle the tax (for which he gets no deduction), sell part of his assets to pay the tax, or simply refuse to honor his tax obligations. Whichever option the taxpayer is forced to adopt can only create problems.

CONCLUSIONS

It cannot be denied that a wealth tax has many advantages over other forms of tax. As our discussion has shown, the tax, if properly structured, is capable of ensuring tax equity, enhancing administrative efficiency, serving as an instrument of economic reform and providing revenue. In Ghana's case the greatest benefit to be expected from the tax is a high revenue yield. But, even this advantage is offset by the problems of payment that are likely to arise. Perhaps this consideration influenced the decision to temporarily suspend the tax. It is not being suggested, however, that a wealth tax can never be appropriate for Ghana. It is my belief that the right conditions for the imposition of the tax do not currently exist in Ghana. For example, it appears unduly burdensome to impose such a tax so soon after almost a decade of serious inflation. I share Surrey's view that the advantages to be derived from this new tax can be obtained through a vigorous implementation of the existing taxes; income tax, capital gains tax, gift tax and the property rates. Ability of taxpayers to pay their taxes is one important factor to be considered when a tax is being proposed. It serves no useful purpose if taxpayers come to regard a tax as a sword of Damocles hanging precariously over their heads. Japan, by abolishing her wealth tax, has already blazed the trail. Ghana only needs to take the first step.

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36. This device is a provision entitling the government to buy the asset at the value placed on it by the taxpayer or at a certain percentage above it. This would enable the government, where the asset is undevalued, to buy the asset and sell no asset at a profit. Fear of this action might prevent under-assessment. It is, however, argued by some economists, notably, Noburu Tanabe that such self-enforcing procedures are questionable and arbitrary, which would of necessity be limited to real estate and could create serious legal problems and problems of equity.
37. See, Nicolas Kaldor, op. cit., (1956), 25-26, and John Strasma, "Market Enforced Self-Assessment for Real Estate Taxes" 19 *Bulletin for International Fiscal Documentation* (1965), 354-363 and 397-414.
38. P.N.D.C.L., 93 S.4(b).

In next issues:

Nordic (Income) Tax Treaty of 22 March 1985

India: Fiscal incentives for the development of scientific research and locally developed technology – by *S.N. Bhargava*

Hong Kong: The UMELCO Report

The Isreali experience of an inflation adjusted tax base, with special reference to Income Tax Law (Adjustment for Inflation) Provisional Measure, 5755-1985 – by *Arye Lapidoth*

The measurement of business income — Part II: Implementation and practice – by *R. Mansury*

The Measurement of Business Income

By R. Mansury

Part I

The Concepts of the Measurement in Theory

Mr. Mansury has written a comprehensive article concerning the measurement of business income. This month we are presenting the first in a two part article. As per the title, this first article will concern general accounting theories. Next month, in Part II, Mr. Mansury will explain the method chosen by Indonesia under the Income Tax Law 1984 and his opinions thereon.

I. INTRODUCTION

When income is looked at as flows of "incomings" it can be classified as:
- income from labor or wages or employment income;
- business income or profits;
- income from capital, such as interest and rent; and
- social security payments or transfers.[1]

Business income together with income from labor are the most important kinds of income as far as tax revenues are concerned. In this essay I would like to deal with the concepts of business income measurements. A sound concept of business income measurement, in any income taxation system, is essential when equity in distributing the tax burden is sought.[2]

I shall deal with the concepts of measurement of business income in theory.

II. THE CONCEPTS OF MEASUREMENT OF BUSINESS INCOME IN THEORY

1. Micro-economic income measurement

According to Irving Fisher, income consists of remuneration for services, including benefits from a property right (such as the interest yield of a bond), benefits from objective instruments (such as the shelter afforded by an office), or benefits from the cooperation of individuals with such instruments (such as transportation service), and the services rendered by individuals, both laborers and professionals.[3] The income is measured for practical purposes in terms of money; it is the sum of all money receipts minus the invested portion.[4]

Fisher described income as a series of psychic experiences called enjoyment coming from consumption of goods and services, and he did not recognize increases in capital as income, because such savings were only potential consumption, as no psychic enjoyment was derived from it.

More recently, economists have not followed Fisher's concept, but have preferred to identify personal income as consumption plus savings.[5]

Hicks developed a general theory of economic income by defining income as the maximum value one was able to consume during a particular period, while still expecting to be as well-off at the end of the period as at the beginning.[6] The purpose of such a definition was to serve as a guide for prudent conduct. Hicks with his "well-offness" concept of income was anticipated by Adam Smith, who also suggested the capital maintenance concept of income.

Adam Smith wrote as follows:

> The gross revenue of all the inhabitants of a great country comprehends the whole annual produce of their land and labour; the neat revenue, what remains free to them after deducting the expense of maintaining; first their fixed; and, secondly, their circulating capital; or what, without encroaching upon their capital, they can place in their stock reserved for immediate consumption, or spend upon their subsistence, conveniences, and amusements. Their real wealth too is in proportion, not to their gross, but to their neat revenue.[7]

Adam Smith's concept of income is especially related to business income, as the capital that should be maintained is fixed as well as circulating capital. Only net income, after deducting expenses for maintaining the capital, is available for immediate consumption, when it is expected not to encroach upon the capital.

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1. Compare:
Cnossen, Sijbren, "Agenda for Income Tax Reform in the Netherlands" in *Public Finance/Finances Publiques*, The Hague: Stichting Tijdschrift voor Openbare Financien, Volume XXVII No. 2/1982, 206,
and:
Marshall, Alfred, *Principles of Economics, An Introductory Volume*, London: McMillan & Co., 1952, 60-69.
2. Edwards, Edgar O. and Philip W. Bell, *The Theory and Measurement of Business Income*, Berkely: University of California Press, 1961, VIII.
3. Fisher, Irving, "Income" in *Encyclopaedia of the Social Sciences*, New York: The MacMillan Company, MCMLXII, Volumes 7-8, 622-625. Also, *The Theory of Interest*, New York: Kelley & Millman, Inc., 1954, 3-35.
4. Id.
5. Lee, T.A., *Income and Measurement, Theory and Practice*, London: Thomas Nelson and sons Ltd., 1982, 7.
6. Hicks, J.R., *Value and Capital, An Inquiry into some Fundamental Principles of Economic Theory*, London: Oxford University Press, 1957, 172.
7. Smith, Adam, *An Inquiry into the Nature and Causes of the Wealth of Nations*, Volume I, Book II, Indianapolis: Liberty Classics, Oxford University Press, 1976, 286-288.

Adam Smith elaborated on the profit or business income by differentiating it from interest as a return on capital and by arguing that it was not a return for the work of "inspection and direction", but rather for the risks in combining the factors of production.[8]

Alfred Marshall developed Smith's concept of income. Marshall's concept can be summarized to include these notions:

- A businessman would not be willing to continue his business unless he expected his total net gains to exceed interest on his capital at the current rate.
- The businessman's profits for the year are the excess of his receipts from his business during the year over his outlay for his business.
- The difference between the value of his stock of plant, material, etc., at the end and at the beginning of the year, is a part of his receipts when there is an increase, and is a part of his outlay when there is a decrease of value respectively.
- What remains of his profits after deducting interest on his capital at the current rate and allowing for insurance, where necessary, is called earnings of the undertaking.
- The money value of the things which constitute his capital has to be estimated and such an estimate is often found to involve great difficulties.[9]

E. Lindahl introduced the notion of income as interest, referring to the continuous appreciation of capital goods over time,[10] and, according to him, capital or wealth was the present value of future anticipated benefits. This view is also in line with the concepts of income and capital of Fisher.[11] Their concepts of capital are represented by the equation:[12]

$$K_o = \sum_{t=1}^{n} C_t (1 + i)^{-t}$$

Where K_o = capital at a point of time, which is 0; C = anticipated future consumption in terms of predicted cash flows; and i = the subjective personal rate of interest.

While the income concept can be identified by the following formula:[13]

$$Y_e = C + (K_t - K_{t-1})$$

Where Y_e = economic income; C = anticipated future consumption in terms of predicted cash flows; K_t = capital at the point of time t (capital at the end of the period); and K_{t-1} = capital at the point of time t-1 (capital at the beginning of the period).

The generally accepted micro-economic concept of business income measures income as an expired portion of capital, while the capital is computed as a discounted future stream of income.[14] The capital at a certain point will be measured as the present value of the anticipated flows of cash to be derived from the capital source. By predicting the future flows of cash we can compute their present value, using fundamental discounting principles.

The micro-economic model of income is based on subjective predictions, because:

- consumption is measured on the basis of predictions of future cash flows; and
- in computing capital or wealth, the discount rate which is applied is the time-preference rate that the manager is willing to invest at the present time.

In a world of certainty it is not very difficult to anticipate future cash flows. But our world is not a very easy world in which to make predictions, as our world is a world of uncertainty. Thus it is not easy to make accurate predictions, which makes it very difficult to measure income accurately using this model.

The discount rate will also vary from one manager to another, so that the capital and income computed under this model can be far from accurate.

Also, this model could lead to an impracticable measurement of income for tax purposes, as this is very much dependent upon future expectations of each taxpayer and it is hard to envisage the tax inspector agreeing with the expectations of each taxpayer.[15] This means that this model cannot be used to measure income for tax purposes.

However, the micro-economic model of income measurement is very useful in analyzing the economic behavior of individuals or individual firms and companies, as this can be used as a guide for their prudent conduct. This model will be useful for such a purpose, because, under the model, income is measured by taking into consideration the value of the capital at the end of the period, which should not be less than it was at the beginning level.

When the measurement of income to be used as a guide for prudent conduct is not suitable to measure taxable income, we must find a measurement of income that meets our needs to measure such income.

There is no single perfect measurement of income that is applicable for all purposes.[16]

Sidney Alexander demonstrates that there are four major types of income as the outcome of four approaches, as follows:[17]

1. *The Comprehensive Equity Change Approach* results in mixed economic income. This approach measures income as an increase in economic capital or net worth of the company.
2. *The Tangible Equity Change Approach* measures income by computing the change of tangible equity

8. Id. at 26, and Volume I, Book I, 103-117.
9. Marshall, Alfred, supra note 1, at 60-69.
10. Belkaoui, Ahmed, *Accounting Theory*, New York: Harcourt Brace Jovanovich, Inc., 1981, 144.
11. Fisher, Irving, supra note 3, at 3-35.
12. Lee, T.A., supra note 5, at 9.
13. Belkaoui, loc. cit.
14. Lee, T.A., supra note 5, at 10, 13.
15. Meade, J.E., *The Structure and Reform of Direct Taxation*, London: George Allen & Unwin, 1978, 31-32.
16. Hendriksen, Eldon S., *Accounting Theory*, Homewood Illinois: Richard D. Irwin, Inc., 3d ed. 1977, 140.
17. Alexander, Sidney S., "Income Measurement in a Dynamic Economy" in Five Monographs on Business Income (Sidney S. Alexander ed. 1973), Houston: Scholars Book Co., 18-25.

value including finished goods valued at cost or valued at market prices minus expected selling cost.

3. *The Operating Profit Approach* measures mixed profit of sales by deducting from the proceeds of sales the total cost of goods sold. The mixed profit of sales is also called accountant's income by Alexander.[18]

4. *The Operating Profits Approach to measure Mixed Profits of Production.* The mixed profit of production can be computed as the difference between the value of goods produced and the total cost of production. The price gain is the difference between the current value of the cost of production and the actual historical cost of production.

As Alexander has stressed, none of the four measurements is the true measurement of income. Which of the measurements is the true one depends on the purpose of the measurement to be performed.[19]

The four foregoing approaches are based on two main concepts: the micro-economic concept and the traditional accounting concept of income. Before describing the traditional accounting concept, it should be mentioned that the micro-economic concept is so subjective and impractical, that it gives rise to criticism, especially as it is not an ideal one for reporting purposes.

2. Traditional accounting income measurement

Accounting income is the income measured by an accounting process, and is used, not to make a valuation, but to record and report the facts.[20]

The traditional accounting concept is based on facts and past transactions, as it is aimed at reaching objectivity and verifiability.[21] In traditional accounting, income is the difference between the realized revenues arising from the transactions of a particular period and the corresponding historical cost, so that this concept involves the following characteristics:[22]

(1) Actual transactions

Income is traditionally measured on the basis of actual transactions entered into by the business entity. The transactions are related to revenues from the sale of goods and/or services minus the costs necessary to produce the goods. The transactions may be explicit or external when they occur with other entities. The transactions are implicit or internal when they occur within the firm itself. External transactions are based on objective evidence, while internal transactions are based on less objective evidence, such as the use or passage of time.

(2) The Period Postulate

The true measurement of income of any business operation cannot be determined until the ownership of the business has been fully terminated and all assets are converted to cash. The net income for the entire life of the entity would be the excess received by the owners, including that received upon liquidation, over their investment in the business. As it obviously would be unsatisfactory to postpone the determination of income until after liquidation, the accounting income is based on the period postulate. In traditional accounting, income is measured for a given period, generally a fiscal year.

(3) The Historical Cost Principle

The historical cost principle dominates the measurement of traditional accounting income, as this measurement requires the measurement of expenses in terms of past acquisition costs. Assets are accounted for at their acquisition cost until a sale is realized, at which time a change in value is recognized. Expenses are expired assets or expired acquisition costs.

(4) The Realization Criterion

A logical consequence of the historical cost principle is the adoption of the realization principle. Traditional accounting requires the definition, measurement and recognition of revenues. Realization is the text for the recognition of revenues, and, consequently, for the recognition of income.

(5) The Matching Principle

The measurement of traditional accounting income adopts the matching principle requiring that realized revenues of the period be related to appropriate relevant historical costs. The past is examined to determine which service potential of the historical cost has expired. When the service potential of the cost has expired, then this cost is allocated or matched with the corresponding revenues of the period.

Proponents of the measurement of income on the basis of the accounting income concept argue that it is based on actual past transactions, so that the accounting income is measured objectively, and it is also verifiable. As this measurement is also based on realization, it, additionally, meets cautionary measurement requirements.

An argument in favor of the traditional accounting income measurement is that since it has been used for so many years, it must be useful to its users, otherwise it would not have survived so long.[23]

Another argument for traditional accounting income measurement is that this measurement discloses what the management has done so that it can be used to evaluate past decisions for better use of the resources entrusted to the management.

The last important argument for traditional accounting income measurement is that the historical cost basis is the least costly. This is because it is less open to dispute than any other measurements as a result of its objectivity and reliability, and also because it is the easiest for preparing the information.

18. Id. at 24.
19. Id. at 25.
20. Lee, T.A., supra note 5 at 47.
21. Lee, T.A., supra note 5, at 55, 57, 65.
22. Belkaoui, Ahmed , supra note 10, at 141-142.
23. Belkaoui, Ahmed, loc.cit.

In contrast to these positive arguments for the traditional accounting income measurement, there are also several negative arguments.

The first criticism of the traditional accounting income measurement is that it does not recognize as income gains that are already accrued, but unrealized in the period in question. In other words: the traditional accounting income measurement does not measure all the income accumulated over the period. Also those parts of income that have already accrued during the prior period and realized during the reported period are considered as income during the reported period, so that this measurement adds up income items that are actually not homogenous, and does not make any distinction between income items gained from production activities and that from mere holding activities.

> This can be demonstrated by a simple example, as follows:
> In 1984 the proceeds of the sales of Company A were 150,000,000. The total cost of goods sold, at the price at the time of acquisition, was 100,000,000. When the cost was based on the prices at the time of sales, the total cost was 120,000,000.

Traditional accounting income is measured by deducting the historical cost of 100,000,000 from 150,000,000 which equals 50,000,000. Under the traditional accounting measurement, there is no distinction between actual sales income of 150,000,000 minus 120,000,000, which is 30,000,000 and the price gain of 120,000,000 minus 100,000,000. The 30,000,000 is the income from the sales, while the 20,000,000 is the gain of holding the asset, due to an increase in the price of the asset by the passage of time.

The opponents to the traditional accounting income measurement also argue that the application of the matching principle requires subjective judgments, as the use of a fiscal year becomes mandatory.[24] For instance, to allocate the costs to acquire fixed assets having service potential for several fiscal years, subjective judgments are needed. Also, to be able to match the costs against proper corresponding revenues, wise jugdments are needed to estimate the useful lives of assets and an advance knowledge of the extent and value of their use in the future is required.[25] Another area in which subjective judgments are needed is inventory valuation. From this, we conclude that the traditional accounting income measurement is not altogether objective and verifiable.

Taking into consideration the respective advantages and disadvantages of the micro-economic measurement of income and the traditional accounting income measurement, efforts are being made to measure income by combining the advantages of the two measurements, while eliminating their disadvantages.

3. The measurement of current value income

The combination of the measurement of income based on current market value and the measurement that is still performed on the basis of past transactions has produced new methods which try to retain the advantages and to eliminate the disadvantages of the microeconomic measurement of income and the traditional accounting income measurement. These methods are called the current value measurements because they measure past actual transactions on the basis of current values.

These methods retain the past transactions values, but they do not ignore value changes. The income under these measurements is distinguished by two categories: current operating income and holding gains. Current operating income is determined by deducting the current cost of related inputs from sales, while holding gains are measured by deducting historical cost from the current cost of the sale-related inputs.

The core of the current value income measurement is that a past transaction is recorded, but when the value of the asset transacted is out of date, because of a change in price, the correct value is incorporated in the measurement. The value changes are taken into consideration, so that unrealized value changes are measured in determining income.

While the traditional accounting income consists of two realized income items, both accrued in the reported and prior periods, the current value income only includes income items accrued in the current period whether realized in the reported period or later. Income items accrued last year are measured as current income of the last year.

By beginning with accounting income and ending with current value income, the relationship of the two measurements can be summarized as follows:

Accounting income
\+ Unrealized income, but accrued in the reported period
− Realized income, but accrued in a prior period
= Current value income.

What are the current values that can be used?
There are two main market prices that are commonly suggested:[26]

a. Entry prices or current acquisition values are prices in the markets at which the business firm could buy the asset in its specified form at a particular time.
b. Exit prices or realizable market values or current realization values are prices in the markets at which the business firm could sell the asset in its specified form at a particular time.

One of the current value income measurements that bases its measurement on entry price is the so-called *Business Income Measurement*. Business income in this context is used in a very specific manner, and not its general meaning as income which is derived from

24. Edwards and Bell, supra note 2, at 8-9.
25. Id.
26. Id. at 75-81.

business activities performed through a business entity or a firm or an enterprise.

The business income measurement, in its specific meaning (which is also termed money income measurement[27]) involves the following characteristics:

(1) Adopting the realization criterion as far as operating income is concerned. No current operation income is recognized until a final sale has occurred. Current operating income is obtained by matching current exit values with current entry costs.
(2) Applying the realization principle with respect to capital gains obtained from mere holding. So, in relation to holding gains, income is recognized in a reported period before a final sale has occurred. A recognition of income is given when an increase in current value has occurred. There are three kinds of holding gains: inventory holding gains, depreciable fixed asset cost saving and capital gains of undepreciated fixed assets.[28] The holding gains are gains due to increases in current values during the reported year. An increase in the current cost of a depreciable asset over its original cost is called cost savings, a savings that is produced from the difference between the current cost and the original purchase price.[29]
(3) Using replacement costs as entry costs. Replacement costs are the sum of current costs of the inputs contained in a particular asset.[30] The basis of the replacement cost is the market price which is also objective in nature.

The market price can be obtained from the commodity markets or dealers' catalogues for inventory and equipment, from the stock exchanges for stocks and bonds, and from the real estate markets for land and buildings, etc.[31]

The *Realizable Income Measurement* is one of the measurements that bases its computation on exit prices or realizable market values, and can be explained as follows:

(1) This measurement abandons completely the realization criterion. Operating income results from business activities involving assets that are held for resale, while non-operating income is obtained from assets that are held for use. The income under this measurement is also segregated between realized and unrealized income. The realized income are the exit value increases that are realized during the reported period. The unrealized income are exit value increases that are not realized during the measured period, but that have already accrued during the prior period.
(2) The essential difference between the Business Income Measurement and the Realizable Income Measurement is that their respective computation is based upon different values. The Realizable Income Measurement bases its computation on current exit values or net realizable values, while the Business Income Measurement bases its computation in current entry values or replacement values. It is generally agreed by the advocates of this measurement that the current exit values that should be used are the selling market prices at the time of measurement under conditions of orderly, rather than forced, realization.[32]

As mentioned earlier, the current value measurements try to find measurements that are superior to both the micro-economic measurement and the traditional accounting measurement.

However, there is some important criticism directed against the current value measurements:
1. When an income measurement is based upon a valuation rather than upon past transactions in terms of values at the time of transactions, the outcome will hide the stewardship information behind value adjustments.
2. An income measurement that is based upon a valuation is also less objective and less verifiable, as a valuation always involves personal judgments.
3. It is not always easy to find a second-hand market for assets similar to those of the business firm concerned.
4. This measurement is more costly and more time-consuming, compared with the traditional accounting income measurement.
5. None of the current value measurements takes into consideration the general price level changes.

It should be noted that the current values are very different from the general price-adjusted values. With current valuation, the historical values are not used at all. They are altogether changed and replaced by new values, replacement values, or net realizable values. With the general price-level adjustment the historical values are not abandoned, but the values are only adjusted to the changes in the purchasing power of the currency. In measuring income, the current value methods do not make any adjustment to the changes in the purchasing power of the money.

Could the current value measurements be used to measure business income (in general terms) for tax purposes?

There are two arguments against the current value measurements that are relevant to a refusal to use these measurements for tax purposes. These are: (1) the measurements are too costly and time consuming, and (2) they are less objective and less verifiable.

There are two methods of assessment available in every tax system, the official assessment method and the self-assessment method. Under the official assessment method, the tax due is determined through an issuance of an assessment notice by the tax inspector and the assessment by the inspector is based upon the tax return of a particular taxpayer. When the particular

27. Lee, T.A., supra note 5, 75.
28. Id. at 77-78.
29. Edwards and Bell, supra note 2, at 93.
30. Id. at 91.
31. Revsine, Lawrence, "On the Correspondence Between Replacement Cost Income and Economic Income", *Accounting Theory & Policy: A Reader*, (Robert Bloom and Pieter T. Elgers ed. 1981) New York: Harcourt Brace Jovanovich, Inc., 253.
32. Belkaoui, Ahmed, supra note 10, at 160.

taxpayer has income from business activities, he must attach, to the return, the annual financial statements of the taxable year concerned. If the taxable income is to be based on the current value, the taxpayer must spend more money and more time to prepare the income statement for the year. Under the self-assessment method the amount of the tax due is determined by the taxpayer by submitting a proper and correct tax return.

Under the self-assessment method, the taxpayer deriving income from business activities must also prepare an income statement (in some jurisdictions with more detailed information) as, in principle, no assessment by an inspector is needed. Under both assessment methods, the current value income measurements should not be used for tax purposes, as these will add heavy compliance costs to taxpayers.

Another argument against using the current value income measurements is that these measurements will create more social costs. To measure current value income an assessment must be made. Every valuation involves personal judgments of the assessor. So there is always a possibility of disputes between taxpayers and the inspector, and such disputes will make the measurements more costly in social terms.

And yet another argument against the current value income measurements is that these measurements will make it extremely difficult for the tax administration to check whether the current values used by the taxpayers are the correct values. As current values are based on market prices, the tax administration must produce a daily list of prices of all assets of the enterprises and all goods that are traded in the society.

CONCLUSION

Therefore, depending upon the quality of the tax administration and its ability to properly assess the values set by the taxpayer, the choice of means to measure income will be made. In a developing society, where the tax system is not fully matured, the traditional accounting measurement will often be the method most easily applied and controlled. The advantages and disadvantages of the various methods must be viewed together with the society which is to implement the policy.

CONFERENCE DIARY

MARCH 1986

Dr. Peter Deubner Verlag GmbH: Körperschaftsteuer-Intensivseminar (Corporate income tax) (Seminar). Munich (German Federal Republic), 1, 8 and 15 March (German).

Seminar Services International: Holding and finance companies (including: Netherlands, Luxembourg, Netherlands Antilles, Channel Islands, Switzerland, Liechtenstein). Amsterdam (Netherlands), 6 and 7 March (English).

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).

The World Trade Institute: Legal and tax aspects of dealing with the boycott (Seminar). New York (U.S.A.), 13 and 14 March (English).

Münchner Steuerfachtagung: Tax conference in Munich. Munich (German Federal Republic), 19 and 20 March (German).

The World Trade Institute: Expatriate tax policies and planning (Seminar). San Francisco (U.S.A.), 19-21 March (English).

The World Trade Institute: Allocation and apportionment of deductions under Treas. Reg. Sec. 1.861-8 (Seminar) New York (U.S.A.), 20 and 21 March (English).

The World Trade Institute: Foreign sales corporations (Seminar). San Franciso (U.S.A.), 17 and 18 March (English).

The World Trade Institute: Introduction to international taxation (Seminar). San Francisco (U.S.A.), 17 and 18 March (English).

The World Trade Institute: Intermediate seminar on international taxation. San Francisco (U.S.A., 19-21 March (English).

Gesellschaft für Unternehmerinformation mbH: Neue Entwicklungen im deutschen Aussensteuerrecht (New developments in German international tax law). Bonn (German Federal Republic), 5 March (German).

Oracle Business Information: Managing a Unit Trust – Taxation and Accounting Requirements. London (United Kingdom), 21 March (English).

APRIL 1986

British Branch of I.F.A.: Tax workshop (subject of topical interest to be chosen shortly before the meeting). London (United Kingdom), 2 April (English).

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).

Ecole supérieure des sciences fiscales: European taxation and investment (including: tax measures or incentives encouraging investment in the following countries: German Federal Republic, Belgium, France, Italy, United Kingdom. The Netherlands, Luxembourg and Spain). The Commission of the European Economic Community will deliver a report. Brussels (Belgium), 25 and 26 April (English and French).

The World Trade Institute: Corporate tax developments (including: fringe benefits) (Seminar). New York (U.S.A.), 28 and 29 April (English).

MAY 1986

The World Trade Institute: Introduction to international taxation (Seminar). Boston (U.S.A.), 5 and 6 May (English).

British Branch of I.F.A.: Recent tax cases. London (United Kingdom), 6 May (English).

The World Trade Institute: U.S. and international tax planning for high technology ventures (Seminar). Boston (U.S.A.), 5 and 6 May (English).

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).

The World Trade Institute: Earnings and profits of foreign subsidiaries (Seminar). New York (U.S.A.), 8 and 9 May (English).

The World Trade Institute: Tax aspects of intercompany pricing (Seminar). San Francisco (U.S.A.), 19 and 20 May (English).

British Branch of I.F.A.: International tax implications of investment into and out of Japan. London (United Kingdom), 21 May (English).

Gesellschaft für Unternehmerinformation mbH: Einführung in die Praxis des Internationalen Steuerrechts (Introduction to the practice of international tax law). Bonn (German Federal Republic), 22 and 23 April (German).

BNA International Inc.: The 12th biannual Tax Management International Forum (Conference); The Impact of the U.S. Tax Reform Act on International Business Transactions. London (United Kingdom), 22 May (English).

The World Trade Institute: Foreign tax credit (Seminar). San Francisco (U.S.A.), 22 and 23 May (English).

The World Trade Institute: Update on current issues in international taxation (Seminar). New York (U.S.A.), 29 and 30 May (English).

JUNE 1986

The World Trade Institute: Legal and tax aspects of foreign investment in U.S. real property (Seminar). New York (U.S.A.), 9 and 10 June (English).

The Worl Trade Institute: Tax planning under Subpart F (Seminar). New York (U.S.A.), 12 and 13 June (English).

The World Trade Institute: Legal and tax aspects of compensating foreign nationals in the United States (Seminar). New York (U.S.A.), 16 and 17 June (English).

The World Trade Institute: Tax aspects of international treaties (Seminar). New York (U.S.A.), 16 and 17 June (English).

[continued on p. 70]

INDIA:

Aspects of the Black Economy

Report of a Study

By Kailash C. Khanna

INTRODUCTION

The National Institute of Public Finance and Policy is an autonomous non-profit organization whose major functions are to carry out research, undertake consultancy work and impart training in the area of public finance and policy. About two years ago, the Institute was asked by the Central Board of Direct Taxes, Ministry of Finance, Government of India, to carry out a study which would identify the important sectors of the economy in which black money is generated; examine the causes that lead to the generation of black money; study the methods employed to generate black money and the channels through which concealed income is invested or spent; examine the means to convert black money into white money; and, finally, attempt a broad estimate of the volume of black money generated. A voluminous report, covering over 600 pages and including numerous tables and charts was submitted by the Institute to the Government of India. This has been recently published for public debate and an attempt is made here to summarize its salient features.

The Report makes a distinction between black income and black wealth, the former representing a flow concept, that is, something which accrues over a period of time and is therefore measured as a quantity per unit of time, and the latter a stock concept, that is, something which has a physical existence and is therefore measureable at any given point of time. The important sectors generating black money have been identified as real estate transaction, construction activity, film industry, large-scale manufacturing, and the professions.

The Report deals mainly with tax evasion arising out of legal economic activities as, in the Institute's view, this probably constitutes the most important source of black income. Pervasive and detailed regulation of economic activity through industrial licensing, import licensing, controls on prices and distribution of goods and services, and various other similar means are another major source of black income generation. Such economic regulations have been a permanent feature of post 1950 Indian economic history, but, according to the Report, there is every indication that the opportunities provided by the regulations have vastly increased. Generally, controls have given a fillip to black incomes in two distinct ways: first, by creating (illegal) scarcity premiums between the controlled prices of the goods, services or assets and the market prices; and, secondly, by vastly augmenting the discretionary authority of functionaries at all levels of Government. In fact, the Report says that the use of discretionary authority to extract or levy illegal tolls has spread far beyond the area of economic controls. Particularly, at the lower levels of the State apparatus, it has become quite common for illegal payments to be demanded in return for regular public services, such as the registration of documents, repair of a telephone, the issue of a tax assessment order, the admission of a student to an educational institution or decisions on postings and transfers in the public services. Moreover, the absolute and relative scale of Government spending has increased dramatically, thereby increasing considerably the scope for making black incomes through kickbacks, cuts and commissions on Government projects, programs and purchases. Further, there are strong indications that political involvement in such transactions has grown enormously. As per the Report, a great deal of political costs are financed from purchases, sales, and contracts awarded by different levels of Government and public agencies, with orders placed abroad being particularly lucrative propositions. In terms of the Report, making of black income has become a very integral, even "routine", dimension of Indian society, encompassing tax evasion on legal source economic activities and wide-spread corruption and abuse of all forms of public discretionary authority.

1. CAUSES OF BLACK INCOME GENERATION

The Report lists the main causes of black income generation as follows:

(i) the level and structure of taxation;
(ii) controls on economic activity;
(iii) general laws and regulations;
(iv) financing of political activities;
(v) government spending; its scale and accountability;
(vi) standards of public morality; and
(vii) inflation.

It is emphasized that these causes operate *together*, not as isolated elements.

(i) The level and structure of taxation

As regards the level and structure of taxation, the Report opines that the composition of taxes has a bearing on the extent of evasion. It is generally believed that indirect taxes on commodities are more difficult to evade than direct taxes on income and wealth. Over the past three decades, the percentage of direct taxes in India has come down from 37% of the total revenue of the Center, States and Union territories in 1950-51 to 17% in 1982-83. Such an atypical trend suggests that the problems of evasion of direct taxes have been unusually severe in India and have militated against the normal growth in the share of these taxes in total revenue. Most of the debate, regarding the relationship between the level and structure of tax rates and evasion, relates to taxes on income, especially non-corporate income, and the focus is on tax *rates*, to the exclusion of other characteristics of tax, such as provisions for exemptions and deductions. "We side with those who believe that high effective rates of taxation are a major contributory factor to tax evasion and black income generation in India. Improved tax compliance *can* result from significant and sustained reductions in the effective tax burdens of those who are liable to tax."

(ii) Controls on economic activities

The range and complexity of controls over economic activity in India is impressive. There are several dimensions to the manner in which controls contribute to the generation of black income. First, and most obviously, in areas such as import licensing, foreign exchange control, rent control and commodity price controls, the institution and operation of controls spawns scarcity premiums over an above the official controlled prices, and these are usually reaped by operators in the black market for the relevant items. Since the transactions in violation of statutory restrictions have to be entered secretly, these must necessarily be kept from the tax authorities. Thus, in consequence, evasion of tax on income made illegally is inevitable. Informed sources attribute great significance to controls as the cause of black incomes. Some of these sources have concluded that the aggregate of illegally based black incomes generated by controls is larger than that of income from tax evasion in India. Any one setting up a new activity has to get approval from a number of different agencies and departments. There is no doubt that at each stage where approval is required there is potential for graft, and this exists at the different levels. The Report quotes the remarks of an experienced Union Cabinet Minister: "We have allowed a huge bureaucratic network to develop as a constraint on them (trade and industry). This apparatus exists only to say 'yes' or 'no' to a project whose file has to pass from the lowest section officer to the highest ministerial office. . . This merry-go-roud goes on not only for months, but for years. The only way to expedite matters and to obtain a 'no objection' certificate is to resort to the lubricant of unaccounted money, which is used at every decision making point, from the lowest to the highest level. This is how corruption becomes the rule rather than the exception." The need to pay regular bribes to different elements of the control apparatus provides productive enterprises with a good reason to generate black income in their operations. "Greasing the wheels of business" is a significant rationale for enterprises to keep some of their income "of the books". And this need is high because the speed, complexity, and discretionary content of the control system is great.

(iii) General laws and regulations

Laws and regulations grant a certain amount of monopoly power and capacity for harassment to those responsible for interpreting and administering them. The discretion is intended to service public interest. All too often it is used to enhance private (and illegal) profit. In effect, in the hands of the unscrupulous, regulatory authority is transformed into levies of "private taxation" through which tolls are levied on the public. The bribes constitute black income in the hands of the recipients and this act encourages donors to generate black income.

(iv) Financing of political activities

Political contributions are raised from a wide range of sources of which industry and trade are believed to be the principal ones. Black incomes, made through tax evasion of income from legal sources along with black incomes from illegal sources, provide the "base" for the political "contribution". Political domination over the apparatus for licenses and permits and over public expenditure ensures means by which this base can be enhanced and individual enterprises induced to contribute at will.

(v) The scale of Government spending

Government spending can be a potent source of economic patronage. In the past three decades, Government spending in India has increased nearly fifty times in absolute nominal terms. Even as a ratio of GNP, Government spending has increased from 9% in 1950-51 to 27% in 1982-83. There is no reason to believe that these expenditures are more readily accountable merely because of the passage of time. "In fact, matters have worsened considerably, especially with the reported growth of political fund raising through Government contracts. Furthermore, this period also saw a very rapid increase in the operations and turnover of public sector enterprises, some of which also offer substantial opportunity for making illicit commission. Thus, it is difficult to resist the conclusion that rapid increase in public spending has been a significant factor behind the growth of black incomes." The most common method of making black income from Government spending is to "siphon off" a chunk of the reported expenditure and diminish the actual materials supplied and work performed by a corresponding amount.

(vi) Standards of public morality

"Everyone we interviewed agreed that the standards in public life have declined rapidly over the last three decades." Among the reasons cited for this steep drop in public morality are the relative decline of old elites and their established values and the rise of new, moneyed elites with little to offer except their example of material success; the example set by political rulers in using public office to advance party and private interest and their apparent ability to flout the rule of the law with substantial impunity; the sharp decline in real incomes of Government servants coupled with growing opportunities for deploying their discretionary authority for personal profit; the cumulative character of corruption; and the growing weakness of established institutions and source of authority. Whatever the reason, the effect on tax compliance cannot be anything but adverse. The process has been hastened by two other factors; the growing role of specialized middlemen who mediate between the citizen and the revenue or other authority; and the virtual universality of black transactions in certain markets (such as urban real estate) which obliges otherwise honest citizens to *flout* tax statutes if they are to participate in these markets at all. Some tax advisers do not hesitate to lend their support in shielding and in even assisting tax dodgers. By all accounts, this practice has become more prevalent. The assessee does not bribe the revenue official, he shifts the burden of the act and the associated guilt to the intermediary tax consultant. A similar role is played by clearing agents with respect to customs authorities.

(vii) Inflation

Inflation, when it is prolonged and severe, increases the incentive to succumb to temptations, such as making windfall gains, which are unlikely to be fully declared to the revenue authority. Moreover, with a progressive income and wealth tax structure defined with respect to *nominal* values, inflation results in "bracket creep" which increases the effective burden of taxation at any given level of *real* income or wealth and provides incentive to evade.

2. METHODS OF BLACK INCOME GENERATION

The methods of black income generation are enormously diverse and vary tremendously across income generating activities. The most common method of generating income from tax evasion is a complete or partial suppression of gross receipts. Another significant device is the exaggeration of expenses. Undervaluation of assets and Benami (fictitious name) businesses are other methods. It is difficult to list all the methods because of their variety.

3. FORMS IN WHICH BLACK WEALTH IS HELD

"When we turn to the uses of black income, it is important to appreciate that a very substantial portion is spent on consumption of goods and services. Thus salary earners and self-employed professionals are much more likely to have a high propensity to consume out of tax-evaded income than business men, who have typically greater access to methods of reinvesting black income in areas where the fear of detection is little and returns are attractive. As regards forms in which black wealth is held, the most important vehicle is provided by undervalued real estate, both residential and commercial. Next is undervalued stocks in business, followed by gold, silver and other precious metals; undeclared holdings of foreign assets and diamonds and other gems come next. Cash is considered to be a very minor holding of black wealth. This is consonant both with our interviews and information and common sense. Unlike all other asset forms, cash yields no return. Furthermore, large quantities of cash are vulnerable to detection in the raids by tax authorities whereas in the case of most of the other assets, problems of establishing ownership and valuation serve as effective lines of defense."

4. METHODS OF CONVERTING BLACK INCOME INTO WHITE

There is a bewildering array of methods for converting "black" into "white", with the different techniques catering to the varied situations and needs of individuals. A widespread technique is through the use of "fictitious bills". The seller sells only the bill to a buyer, there being no corresponding delivery of goods or services. Manipulations of stock market transactions constitute another significant avenue for converting "black" into "white".

Generally speaking, anyone with business or professional income can always inflate sales and profits (against fictitious receipts, where necessary) to bring more income "on to the books", that is, to convert black to white. The trick lies in doing it in a manner which minimizes the incremental tax liabilities.

The transformation of "black" to "white" via foreign exchange (sometimes described as the "black to green to white route") is gaining rapidly in importance with the Government's desire to attract investments and remittances from non-resident Indians. Finally, there is the obvious method by which black wealth can be converted into white, namely, through the medium of consumption.

5. IMPACT ON FISCAL SYSTEM

Widespread tax evasion has serious consequences for the economic fiscal system. The most obvious consequence is the loss of revenue. The long run consequence of such loss is to reduce the built-in elasticity of the tax system. Large scale tax evasion also undermines the equity of the tax system; "horizontal equity" is breached since the effective burden of taxation differs widely between assessees with comparable levels of income. "Vertical equity" also becomes a casualty when an assessee's tax liability has less to do with this ability to pay and more to do with his ability to evade. Evasion also blunts the allocational signals of the tax system. In a longer view, widespread tax evasion restricts the scope for tax reform. Finally, to the extent "black incomes" are reaped through "siphoning off" from public programs and projects, the expenditure side of the fiscal system is also affected.

One fundamental question is whether tax evasion, illegal incomes, corruption and other phenomena associated with the black economy lead to more or less output and growth than would have been the case in their absence. The issues involved are complex. One view emphasized that in many instances, where a transaction generates black income, economic efficiency is improved and national welfare enhanced. For example, it was argued, that strict compliance with onerous tax laws could lead to sharp reduction in work effort, enterprise and savings. Evasion reduces the effective burden of taxation to levels where disincentives to work and save are contained and the loss of potential output reduced. Smuggling of goods subject to quantitative restrictions can augment national welfare. As for corruption, "speed money" can reduce delays and costs and improve economic efficiency. "We readily concede that given the present structure of taxation and economic regulations many institutions can be found where black transactions improve economic efficiency. But we would be loathe to accept any general proposition based on such examples."

Bribes can be seen as "taxes" collected by the officials who wield the effective monopoly for their private gain. L.K. Jha, at present Economic Adviser to the Prime Minister, once stated: "Today there is hardly a single transaction left between the ordinary citizen and a government servant from which the latter does not extract "rent". The term "private taxation" seems particularly apposite here since the tolls certainly have a mandatory aspect to them and they are quite obviously for private gain." Smuggling, black marketing in foreign exchange and invoice manipulations of trade are an integral part of the black economy.

6. SOME WIDER ISSUES

The consequences of the black economy are not limited to the economic domain, they extend far beyond into politics, administration, social values and so forth. The non-economic consequences of a burgeoning black economy and cumulative corruption include: growing arbitrariness in public policy which can be increasingly manipulated by money power; the progressive substitution of professionally trained and oriented techno-managerial elites by new clasess of "fixers" and manipulators (and even criminals) who thrive on the symbiosis between complex and corruptible systems of taxation and rent-generating controls and corrupt politics; the associated decline of "old values" of honesty, thrift, cooperation and diligence and the rise of a far more amoral (if not immoral!) culture which defines the individual pursuit of material wealth, irrespective of the means employed; the steady erosion of public institutions as these are increasingly subverted to partisan or private profit; and, finally, the cumulative weakening of the entire politico-administrative system, as it becomes progressively undermined by the short-term pursuit of private profit and power (on the part of the incumbents) at the expense of long-range public interest.

7. A GLOBAL ESTIMATE OF BLACK INCOME GENERATED

According to the Report, the global estimate of black income generation in the Indian economy ranges from Rs. 9,958 crore to Rs. 11,870 crore in 1975-76 and from Rs. 20,508 crore to Rs. 23,678 crore in 1980-81 (one crore = ten million). In terms of percentage of GDP, these estimates range from 15% to 18% in 1975-76 and from 18% to 21% in 1980-81. Assuming that the same percentage of GDP were generated as black income in these sectors in 1983-84, the absolute amount of black income generated could be estimated to range from Rs. 31,216 crores to Rs. 36,418 crore. "We would say with some degree of confidence that black income generation in the Indian economy in 1983-84 cannot be placed below 18% of GDP at factor cost, or 16% at market price." It must be noted that the above estimate excludes black income that is generated through smuggling, black market transactions, acceptance of bribes, kickbacks of some kind, and prostitution. However, if the amount of black income estimated to be generated in relation to import licenses (Rs. 118 crore) and that generated through smuggling of gold (Rs. 250 crore) is taken into account, the proportion of black income generated in 1983-84 to GDP at factor cost was probably in the region of 18% to 21%. Further study would be required to get sufficient evidence to say that it might even range up to 30% of GDP at factor cost. It would be instructive to note that a recent IMF study is reported to have placed the percentage figure at 50.

8. MEASURES RECOMMENDED FOR REDUCING BLACK INCOME GENERATION

The first requirement for tackling the problem of black income generation is clean administration, at least at the level of political authority and the top civil servants. Given this desideratum, a package of effective measures would include: (i) change in economic and related policies; (ii) measures designed to bring down the amount of black wealth currently held; and (iii) policies relating to administration and enforcement of taxes.

Direct taxes are levied on a number of bases and the cumulative burden of taxation works out to be quite high. "We recommend that tax on company profits, the personal income tax, the wealth tax, stamp duty, and the estate duty all be reduced substantially. There is also need to scale down excise duties and sales taxes." The reduction in the rates of excise and customs duties could, while improving tax compliance, also be expected to bring down the volume of smuggling.

The results contained in the Report indicate a positive link between the levels of black income and the aggregatc tax ratio of thc cconomy. This would suggest that the tax ratio should not be increased any further if black income generation is to be controlled. However, with the development of the economy, a rise in the ratio brought about through an automatic increase in revenue derived from a moderately progressive, stable, and uncomplicated tax structure should not contribute to an increase in the relative magnitude of tax evasion. The more complicated the tax structure and the larger the number of deductions, exemptions and concessions, the more difficult it is to enforce the taxes concerned. There is therefore a greater scope for collusion between tax authorities and the taxpayers. A country like India needs the simplest tax structure that can be constructed consistent with the requirements of revenue and equity. Moderate rates combined with broad bases without too many deductions and concessions are preferable to a regime of high rates moderated with a plethora of concessions. The Report estimates that income that has evaded taxation rose to between 74.21% and 76.99% in 1980-81. In other wordss, not more than 25% of the income liable to tax is actually taxed! Reforms in the tax structure, by itself, are unlikely to have much influence on black income from illegal sources. Consequently, the economic case for substantial deregulation is strong, particularly, as controls, permits, and licenses play an important part in spawning illegal source black income. Suitable adjustments should be made in the exchange value of the rupee and exchange controls should be eased.

Since politicians have to depend to a considerable extent on funds to be supplied by businesses for meeting election expenses, one of the important measures to be undertaken to remove a major source of demand for black money would be to permit companies and businesses to make donations to recognized political parties out of after-tax profits. Further, state funding of election expenses within specified limits and conditions should be undertaken.

Two major requirements for promoting high standards of honesty among senior officials are: (i) a system of rewards and punishments; and (ii) significantly higher levels of remuneration than existing at present.

9. MEASURES TO BRING DOWN THE BLACK WEALTH CURRENTLY HELD

Certain measures can be initiated to induce the conversion of black wealth into white money. To achieve this purpose, a two pronged approach is needed. First, the Government should devise a scheme or schemes to induce the black wealth holders to bring the wealth out in the open. For instance, it is possible that society may not seriously object if black money is obtained by Government, while giving immunity to those who are giving it, for achieving a noble social objective. The clearance of slums is one such objective. Simultaneously, with the announcement of a scheme or schemes, it should be made clear to those liable to taxation that having brought down the tax rates to reasonable levels and having given an opportunity to those who have erred in the past, Government would deal harshly with tax evaders in the future. Accordingly, steps must be initiated to bring about substantial improvement in tax administration and to tighten and strengthen the provisions relating to punishment of tax evaders.

Finally, effective administration of tax codes requires integrity and probity among revenue officials at all levels. Much will depend on the integrity of the political leadership, including its willingness to abstain from using the fiscal administration for narrow political ends.

10. GOVERNMENTS'S REACTION AND ACTION

The Report is being studied by officials of the Finance Ministry and the Government's detailed reactions are awaited. In the meanwhile, personal tax rates were reduced in the last Budget and companies have been permitted to make contributions to recognized political parties out of taxed profits, subject to specified regulations. The tax administration is being tightened and a few top tax officials have been removed from service. Search and seizure have been intensified and tax raids carried out at several places, including the business and residential premises of some eminent industrialists. Committees have been set up to examine the feasibility of a tax on expenditure and to suggest a reform of the direct tax structure. A modified value added tax has been proposed, and customs tariffs and excise classification may be simplified. A long term fiscal policy has recently been announced by the Finance Minister, the main points of which have already been published in Tax News Service.

TAIWAN:
Tax Changes for 1986

By K.S. Jap

The Legislative Yuan has set out the following income tax changes for 1986. The standard deduction for personal allowances per year are in NT$:

For a single taxpayer	30,000 (unchanged);
For a married taxpayer	60,000 (unchanged);
For each dependent	26,000 (was 24,000).

The individual income tax rates have been reduced by increasing the taxable income brackets as hereunder and reducing the maximum rate from 60% to 50%.

Consolidated income tax rates (individual income tax)

Taxable income (NT$)	*Tax rate*
less than 80,000	6
80,001 – 160,000	8
160,001 – 260,000	10
260,001 – 380,000	12
380,001 – 550,000	15
550,001 – 730,000	18
730,001 – 1,000,000	22
1,000,001 – 1,400,000	26
1,400,001 – 1,800,000	30
1,800,001 – 2,300,000	34
2,300,001 – 2,800,000	39
2,800,001 – 3,500,000	44
more than 3,500,000	50

The profit-seeking enterprise income tax rates (corporate income tax) have also been substantially reduced. The new maximum rate is 25% and is levied on taxable profits exceeding NT$ 100,000 (previously 30% on more than NT$ 500,000).

The profit-seeking enterprise income tax rates

Taxable profits in NT$	*Tax rate*
Less than 50,000	Exempt
Between 50,000 to 100,000	15% on total taxable profit, but the tax shall not exceed 50% of the excess of taxable profit over 50,000 NT$
More than 100,000	25%

It should be noted that the Statute for Encouragement of Investment sets the maximum rate of the profit-seeking enterprise income tax levied on a productive enterprise and a big trading company as follows:

- productive enterprises in general, as defined in Article 3 of the Statute for Encouragement of Investment, big trading companies and Venture Capital Investment Enterprise: 25%;
- productive enterprises engaged in basic metal manufacturing, heavy machinery manufacturing, petrochemical industries, or other capital-intensive or technology-intensive industries which contribute to the national defense or economic development as prescribed by the Executive Yuan: 22%.

FIJI:
An Outline of the Budget Tax Proposals for 1986

By Dennis J. Olmstead

In a speech on 8 November 1985 dominated by mixed projections concerning the development of the world economy, the Minister of Finance, the Honorable Mosese Qionibaravi outlined the Budget for Fiji for 1986. In marked contrast to the pessimistic forecasts of other nations, the Minister exhibited hope evolving out of the decline in the foreign exchange rate of the dollar and a steady erosion of the commodity stockpiles which could result in a slow increase in commodity prices.

With plans to stimulate investment activity, raise the standard of living, re-train the jobless, develop tourism, continue the freeze on wages and salaries in the government sector, and aid agricultural efficiency, the Government presented substantial changes in the tax system with an overall shift from direct taxation to indirect taxation. From 1983-85 customs and excise duties contributed 35% of General Revenue, and Inland Revenue 45%. Following the program announced by the Minister of Income, customs and excise duties will contribute 43% of General Revenue, with 38% coming from Inland Revenue. A proper review of these changes is necessary to keep abreast of the plans in this dynamic nation.

DIRECT TAXES

The following tax changes are effective from 1 January 1986.

1. Income tax threshold increased

In order to offset the shift of the burden to the lower income levels, people on fixed income and the unemployed, which generally arises when indirect taxes are implemented, the Government has increased the current threshold of F$ 1,500, at which tax becomes payable, to F$ 2,000. Any individual earning under this amount is exempt from income tax.

2. Individual income tax rate changed

An across the board reduction of the tax applicable to individuals will be implemented to lessen the burden of direct taxation. The maximum rate of tax will apply to chargeable income of F$ 40,001 and above, as compared with the existing level of F$ 20,001 and above. The new schedule is as follows:

When the taxable income is –	Tax on taxable income
not over 1,500	5 % of taxable income
over 1,500 – 3,000	75.00 plus 10 % of taxable income over 1,500
over 3,000 – 4,000	225.00 plus 18 % of taxable income over 3,000
over 4,000 – 5,500	405.00 plus 27.5% of taxable income over 4,000
over 5,500 – 7,000	817.50 plus 32.5% of taxable income over 5,500
over 7,000 – 9,000	1,305.00 plus 37.5% of taxable income over 7,000
over 9,000 – 15,000	2,055.00 plus 42.5% of taxable income over 9,000
over 15,000 – 25,000	4,605.00 plus 45 % of taxable income over 15,000
over 25,000 – 40,000	9,105.00 plus 47.5% of taxable income over 25,000
over 40,000	16,230.00 plus 50 % of taxable income

3. Wife's investment income

As women assume a more active role in the market, it has become apparent that they must be granted independent status in regard to their income.

Therefore, when a wife's income arises from her own savings, or from her own assets acquired from her own savings, or from inheritance, such income may be separately assessed for tax purposes.

4. Donations deduction increased

The maximum deduction for donations is increased from F$ 50 to F$ 100.

5. Non-resident company tax rate is increased

The tax rates for non-resident companies conducting business in Fiji or operating in Fiji as branch operations of foreign companies, are increased as follows:

(i)	Non-resident companies carrying on business in Fiji (other than non-Fiji shipping companies, in respect of all outgoing business from Fiji, whether freight or passengers, non-Fiji mutual insurance companies in respect of life insurance business and non-Fiji proprietary or non-mutual unsurance companies to the extent that the income of life insurance business is deemed to be mutual under subsection (1) of section 37)	45%
(ii)	Non-resident mutual insurance companies in respect of life insurance business	30%
(iii)	Non-resident or non-mutual insurance companies to the extent that the income of their life insurance businesses is deemed to be mutual under subsection (1) of section 37	30%
(iv)	Non-resident shipping companies in respect of all outgoing business from Fiji, whether freight or passengers	2%
(v)	Every other company	35%

6. Taxation of fringe benefits

In an attempt to achieve greater equity among taxpayers, amendments have been made to the Income Tax Act which will tax all fringe benefits.

This will include:

- subsidized interest rates on loans to employees;
- free or discount air or sea passages provided to airline or shipping employees and those associated with the travel industry;
- discounts granted to employees in respect of goods purchased from the employer;
- perquisites arising from any business dealings; and
- contributions to a retirement or superannuation fund exceeding the minimum statutory contribution required to be made by the employer or any amount of contribution which the employer is entitled to recover and which is not recovered.

7. Exemption to pensioners

To alleviate the burden of taxation on resident pensioners, in addition to the age allowance relief, pension income to the extent of $ 1,000 will be exempted from tax.

8. Exemption of reinsurance premiums

To assist the insurance industry in seeking overseas reinsurance cover, tax payable on reinsurance premiums remitted overseas will be exempt for one year effective as of today.

II. INDIRECT TAXES

1. Excise duties and import duties

A comprehensive list of increases in excise duties was also presented in the annual Budget Speech. Major increases have been noted in regard to tobacco and alcoholic beverages.

These same items, along with oil and motor fuels are being subjected to increased import duties. Import duties on products which are produced locally are also being increased to rates as high as 100%.

2. Extension of services and turnover covered by miscellaneous services

The existing range of items liable to the 5% turnover tax will be extended to include:

- admission charge in respect of live entertainment provided by local and overseas artists;
- tickets purchased in respect of sea or air travel outside Fiji;
- payments for services of advertising agents and for commercial advertising in press, magazine, radio, theatre, T.V., billboard, etc.;
- retail sales of alcoholic beverages;

- payment for charter of yacht for recreational purposes;
- payment for the purchase of lottery tickets in respect of local and overseas run lotteries.

3. Increase in airport departure tax

Airport departure tax is increased from $ 5 to $ 10 with effect from 1 January 1986.

Increases in customs and excise duties are broadly categorized as follows:
(i) Revenue generation by duty increases on excisable goods and expansion of the excise base.
(ii) Revenue generation by duty increases on non-essential items and through revenue generation areas.
(iii) Revenue generation through protective rates of duties as assistance to local industries and as an encouragement for the utilization of import substitutions.
(iv) Revenue generation through removal of anomalies and alignment of rates disparity due to the increase and diversification of import substitution.

CONCLUSION

The Minister noted that, by way of a mixed blessing, the cyclones which caused considerable damage to the islands resulted in a surplus in accounts for 1985, because of the insurance payments made to cover the damages.

In order to be successful in 1986 Fiji must see some positive results arising out of the shift to indirect taxation. It can only be hoped that this will be the first year in a series of years which develop this new tax scheme.

MALAYSIA:

An Outline of the 1985 Budget Tax Proposals

By Dennis J. Olmstead

I. INTRODUCTION

On 25 October 1985, the Minister of Income, the Honorable Encik Dain Zainddin, delivered his Federal Budget Speech to the House of Representatives. Opening his speech with an overview of the status of the international economy, the Minister stressed the need for open markets and rejected the short-sighted implementation of protectionism. Reminding his audience that the industrial countries are Malaysia's major trading partners and that these nations are facing slowed growth, expected to be 2.8% in 1985 as opposed to 4.9% in 1984, and high unemployment which increase the pressure to interfere with free trade.

Under these conditions Malaysia must continue:

> "Firstly: to strengthen the Balance of Payments and the Budget, through further restraints on public sector expenditures; and
> Secondly: to further stimulate private sector business activity."

The Malaysian economy experienced strong growth of 7.6% in 1984 while only 5.2% in 1985. The Minister attributed this decline to "weak external demand, higher interest payments, and cutback in our crude petroleum production." Malaysia's growth still remains high above the average of 2.7% for Asean countries and 3.6% for all developing countries.

The deficit in Balance of Payment of $ 5.3 billion for 1985 is up from $ 3.7 billion for 1984. To diminish this outflow of foreign exchange the Minister has given top priority to the improvement and expansion of tourist facilities. The decision to stimulate private sector business activity and to restrain public sector expenditures has resulted in the following plans.

II. LIMITING PUBLIC EXPENDITURES

The freeze on the fitting of vacant posts and the creation of new posts, whenever possible, in the Government shall continue. To further aid in this contraction of public employees, the Minister announced that ways by which various sectors of public service can be privatized are being reviewed. Mr. Zainddin noted that only 1 in 84 persons in Great Britain is employed by the government, the Malaysian government, as of 1983, employed 1 in every 17 of the population. Salary increases will also be restricted in order to keep general expenditures down.

III. SPECIFIC CHANGES IN TAXATION

Direct taxes

[Tax changes effective from the year of assessment, 1986]

1. Tax exemption on profits earned abroad

On the belief that there are substantial funds abroad owned by Malaysians, the Government would like to encourage the remittance of these funds to help finance the country's growth.

Therefore, the Government is granting an amnesty on all commission income paid to Malaysians abroad for services performed in Malaysia. This is applicable to commissions received prior to the year of assessment, 1986.

Furthermore, the Government proposes to exempt 50% of this income from taxation. To enjoy this amnesty and exemption taxpayers must declare these commissions in their 1986 tax returns.

Income earned outside the country will receive a 100% tax exemption if it is brought into Malaysia between 25 October 1985 and 31 December 1986. This income may be declared as earned in the relevant years of assessment. The income must be in Malaysia prior to the filing of the returns for the relevant year of assessment. Income of banks, airlines, and shipping lines are ineligible for this exemption.

2. Tax exemption on approved and long-term loans

Currently, interest paid to non-residents for approved and long-term loans is exempt from the 15% withholding tax. It is felt that this encourages foreign borrowing in the private sector.

In an attempt to curb this activity, the exemption for long-term loans is withdrawn and the 15% withholding tax applicable thereon is increased to 20%. However, since the country continues to need foreign loans, tax exemption on interest payments accruing to approved loans will be retained. In line with the Government's austerity plans, approved loans will be restricted to loans obtained by the Federal Government, State and statutory bodies, and loans and credit guaranteed by the Government.

Loan agreements for the above purposes must be executed in Malaysia unless approved by the Minister to be executed outside the country. This proposal is effective as of 25 October 1985.

3. Withholding tax on interest payments

Presently, interest paid by commercial banks and financial institutions on fixed deposits of less than 12 months and saving deposits above certain amounts are subject to tax.

In order to more easily collect this tax, the Minister has proposed a withholding tax on non-exempt savings of 5%, to be collected by banks and financial institutions on behalf of the Revenue Department. It is hoped this low rate of tax will encourage savings on a longer term. This is a final tax and individuals will not be taxed again on their interest income. The proposal is effective as of 1 January 1986.

4. Tourism incentives

a. *Pioneer status*

Pioneer status incentives will be granted for a fixed period of 5 years. Its commencement is from the date of production as determined by the Ministry of Trade and Industry.

b. *Investment tax credit*

The investment tax credit will be granted up to a maximum of 100% on capital expenditures that are likely to be utilized within a period of 5 years. The relevant dividend income is exempted from tax.

c. *Tourist group tax abatement*

Each tour operator, registered and approved by the Tourist Development Corporation, who brings in at least 500 tourists through group inclusive tours will be given a 10% abatement on income derived from the business of bringing in the foreign tourists.

The above proposals will take effect from the year 1986.

c. *Service tax*

Service tax in the hotel and restaurant industry will be reduced from 10% to 5% in an attempt to further encourage the tourist industry.

This proposal is effective 1 January 1986.

5. Manufacturing incentives

In an attempt to simplify the present incentives for the manufacturing sector, which were formulated in 1968, the Minister has proposed:

a. Pioneer status be granted on the basis of priorities as determined by the Government, regardless of the size of the investment. As in the tourism sector, the incentive shall be for 5 years commencing from the production date as set by the Ministry of Trade and Industry.

b. ITC shall be retained with a maximum rate of 100%.

c. The accelerated depreciation allowance (ADA) and reinvestment allowance (RA) are to be extended for another 3 years, that is, up to the year 1988. The extended ADA is in the form of an initial allowance of 20% and an annual allowance of 40%. This proposal will take effect from 1 January 1986.

d. Existing export incentives and double deduction for export promotion expenses are to be abolished. In their place an abatement of adjusted income is introduced. The abatement will be based on the manufacturer's actual performance at the rates stipulated below:

   (i) Abatement of adjusted income equivalent to 10% of the value added in exports.
   (ii) Abatement of adjusted income of 5% for location.
   (iii) Abatement of adjusted income of 5% of the value of local materials used in exports. Such materials should be manufactured in this country.
   (iv) Abatement of adjusted income of 5% of the value of approved indigenous local materials used in the manufacture of exports. Indigenous local material means materials that are grown, reared or extracted locally.

e. Small scale manufacturers are to be given a special abatement of 5% of adjusted income for a period of 5 years. Another 5% abatement is to be given if the small scale manufacturer complies with the New Economic Policy. Small scale manufacturer means a manufacturer with a shareholder's fund of not more than $ 200,000 and fixed assets of not more than $ 1 million. Together with this special incentive, small scale manufacturers are also given the opportunity to enjoy abatement of adjusted income as in paragraph (d) above.

6. The following incentives are to be abolished

(i) Labor utilization relief.
(ii) Locational incentive.
(iii) Export allowance (except for agricultural products).
(iv) Increased capital allowance.
(v) Industrial building allowance.

New manufacturers will be given an option to choose between abatement of tax or pioneer status/investment tax credit. Existing manufacturers, on completion of their incentives, are eligible to enjoy the abatement of adjustment income incentive.

This proposal is effective from the basis year 1986. The bill to implement this proposal will be tabled at the next session of Parliament. Manufacturers currently enjoying or those who have been approved tax incentives before this new proposal is implemented will continue to enjoy the said incentive as provided under the present Act.

7. Import duty on raw materials

The manufacturing sector will be further assisted by a reduction of the import duties on raw materials which are not produced in the country. Most of these duties presently vary from 2% to 5%. These duties on raw materials will now be reduced to a uniform rate of 2%. Manufacturers who are engaged in export production will continue to be completely exempted from all import duties.

In view of the frequent complaints about delays in getting approvals for duty exemptions or duty drawbacks, manufacturers will now be allowed to use bank guarantees in lieu of payment of import duties. Manufacturers are to contact the Customs Department for further details on the use of bank guarantees in importing raw materials.

8. Excess profits tax

The existing excess profits tax, tin profits tax and timber profits tax are all supplementary taxes on the incomes of companies. But, they are levied in different ways. It is therefore proposed that these supplementary taxes should be rationalized and standardized into one excess profits tax. The rate of the new excess profits tax will be 3% and the current franking limits of $ 200,000 or 25% of shareholders funds will be changed to $ 2 million. This excess profits tax will apply equally to both resident and non-resident companies. The existing tin and timber profits tax will be abolished and will be replaced with the new excess profits tax.

IV. CONCLUSION

Beyond these major plans to stimulate the economy of Malaysia during the expected period of international recession, the Minister has proposed tax incentives and allotted large amounts of the budget for infrastructure development.

The result of Mr. Zainddin's proposals will be seen in future months or years, but it is obvious he has taken an aggressive stand in attempting to keep Malaysia competitive in the world market place as well as to develop his nation and increase the standard of living for all its citizens.

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[continued from p. 60]

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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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ARGENTINA:

Compulsory Loan Based on Savings Capacity

By M. Gª Caballero

Within the context of the tax reform undertaken by Argentina[1] a mandatory 2-year savings scheme in the form of a compulsory loan to the Argentine Government has been introduced.[2] The amount of the loan is determined on the basis of each taxpayer's "presumed" savings capacity, by reference to the years 1984 and 1985, instead of on the amount of income tax and net wealth/worth tax *actually paid* for such years. The following is a discussion of this subject.

A. TAXPAYERS

Qualifying lenders for compulsory loan purposes are, in principle, all resident individuals, undivided estates, companies, permanent establishments of foreign enterprises, and individual firms subject to income tax (impuesto a las ganancias) and net wealth tax (impuesto al patrimonio neto) or net worth tax (impuesto sobre los capitales) in respect of the taxable periods 1984 and 1985 (assessment periods of 1985 and 1986).

B. SAVINGS CAPACITY

The amount of the loan of each resident taxpayer is established by taking a percentage of the taxpayer's "presumed" taxable capacity in respect of the net income derived and net capital held, as shown in the 1984 and 1985 tax returns. However, as the taxable capacity of a lender is based on a presumption, "iuris tantum" (i.e. it is rebuttable by the taxpayers on the basis of substantiated evidence), it is provided that, under given circumstances, taxpayers are either exempted from the obligation of making this compulsory loan for the two mandatory years, or such obligation is adjusted proportionately.

(1) Exempt taxpayers

For compulsory loan purposes, taxpayers are exempted from the obligation to make compulsory loans for both of the two mandatory years, in respect of their taxable capacity for 1984 and 1985, under the following circumstances:

(a) Individuals and undivided estates

Resident individuals and undivided estates are exempt from the obligation to make compulsory loans, in respect of both income and net wealth, when they are either incapacitated, unemployed, or have lost 80% or more of their income-generating capital when compared with 1984.

(b) Corporations, partnerships limited by shares, limited liability companies and permanent establishments

Resident corporations, partnerships limited by shares, limited liability companies and permanent establishments are exempt from the obligation to make compulsory loans, in respect of both income and net worth, when they have either been declared bankrupt (under court order) or they have lost more than 60% of their income-generating capital in comparison with 1984.

(c) Other types of legal entities, sole proprietorships and individual undertakings

Other types of resident legal entities (e.g. general and limited partnerships, civil companies, foundations and cooperative societies) and individual firms are exempt from the obligation to make compulsory loans only in respect of net worth (thus, they are liable to make this loan in respect of income) when they have either been declared bankrupt (under court order) or they have lost more than 60% of their income-generating capital in comparison with 1984.

(2) Proportional adjustment of the loan

The savings capacity for compulsory loan purposes is reduced in proportion to the capital loss incurred under the following circumstances:

(a) Individuals and undivided estates

Where an individual (including undivided estates) loses more than 20% of his income-generating capital (without exemptions) when compared with 1984, the amount of the compulsory loan for either year, in respect of both income and net wealth, is reduced proportionately to the amount of such loss.

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1. An avalanche of tax reform bills was submitted by the Government to the Congress in April 1985. Most of these bills have been passed and enacted by law. The tax reform undertaken by Argentina affects direct taxes (on income and capital) and indirect taxes (on transactions).
2. This compulsory loan was introduced by Law 23,256/85, which was enacted through Decree 1,889 of 2 October 1985 and implemented by Decrees 2,073 of 29 October and 2,164 of 8 November 1985 and Resolutions 2,575 and 2,576 of 7 November 1985.

(b) Any type of company, permanent establishment or individual firm

Where a company (including partnerships, permanent establishments and individual firms) loses more than 20% of its income-generating capital (without exemptions) when compared with 1984, the amount of the compulsory loan for either year, in respect of both income and net worth, is reduced proportionately to the amount of such loss.

C. PAYMENT/REPAYMENT OF THE LOAN

The loan must be deposited in two annual installments with the National Savings and Investment Bank (CNAS) through any authorized local bank. The deadlines are:
- 15 November 1985 (22 November for companies and permanent establishments) in respect of 1984 savings capacity; and
- 15 November 1986, in respect of 1985 savings capacity.

Where the amount of the first loan installment is equal to or exceeds 100,000 australes (US$ 1 = 0.80 austral), the amount may be deposited in two equal and consecutive monthly installments (i.e. 15/22 November and 16/23 December 1985). Interest (at prevailing rates for savings deposits with the CNAS) is capitalized (i.e. added to the principal) on a yearly basis. The amount lent, as increased by the interest, will be repaid by the Government 5 years after the date on which the yearly installment was made (i.e. 15/22 November 1990 and 1991) without attracting any tax.

D. AMOUNT OF THE COMPULSORY LOAN

The taxpayer's saving and lending capacity is calculated through a sort of "exemption with progression" method. In accordance with this method, the amount of the yearly loan to the Government is determined by taking into account elements of income and capital which are otherwise excluded from the basis on which the Argentine income tax and net wealth/worth tax are assessed for the year concerned (i.e. the method aims at establishing the combined amount of income tax and net wealth/worth tax which the taxpayer would have to pay in 1985 and 1986 – by reference to the preceding years – if certain items of income and capital would not have been excluded from the pertinent tax).

The income tax liability (which is the first amount on which the compulsory loan is calculated) is assessed by applying the appropriate income tax rates to the taxable income for compulsory loan purposes. For the first loan installment, individual taxpayers must assess the income tax liability in accordance with the progressive tax rates applicable in 1984 (see Table I). At the same time, companies must assess their income tax liability at 33% and permanent establishments at 45%. This income tax liability in pesos must be adjusted, multiplying it by a coefficient of 5.58 (i.e. the coefficient of variation in the country's general wholesale price index for the period November 1984 – October 1985). The resulting amount (converted into Australes at parity of 1,000 pesos : 1 austral) is the taxable capacity, in respect of income. The amount of the loan, in respect of income, is 40% of such taxable capacity for individual taxpayers and 30% for corporate taxpayers (this being the savings capacity).

Table I
Income Tax Table

Taxable year 1984
(Assessment year 1985)

Taxable bases (pesos)	*Fixed amount + percentage on excess*
— – 65,413	0 + 7
65,413 – 152,662	4,579 + 8
152,662 – 239,879	11,559 + 9
239,879 – 348,933	19,409 + 10
348,933 – 479,759	30,314 + 11
479,759 – 654,225	44,705 + 12
654,225 – 828,691	65,641 + 13
828,691 – 1,090,406	88,322 + 15
1,090,406 – 1,417,503	127,579 + 17
1,417,503 – 1,744,632	183,185 + 19
1,744.632 – 2,071,760	245,340 + 21
2,071,760 – 2,507,910	314,037 + 23
2,507,910 – 3,053,113	414,351 + 26
3,053,113 – 3,598,285	556,104 + 29
3,598,285 – 4,143,488	714,204 + 32
4,143,488 – 4,797,744	888,669 + 35
4,797,744 – 5,451,970	1,117,659 + 38
5,451,970 – 6,542,345	1,366,265 + 41
6,542,345 – —	1,813,319 + 45

The net wealth tax liability (which is the second amount on which the compulsory loan is calculated) is assessed by applying the progressive rates applicable in the year in question to the taxable net wealth for compulsory loan purposes. Accordingly, where the taxable amount of the net wealth in respect of 1984[3] is more than 11,237,426 pesos (i.e. 50% of the 1984 net wealth tax-free limit), then the net wealth tax liability for 1985 compulsory loan purposes is assessed in accordance with the progressive rates indicated in Table II. If such amount is equal to or less than 11,237,426 pesos, the person concerned is exempt from the compulsory loan obligation in respect of his 1984 net wealth. Where the taxable amount of net wealth in respect of 1985[4] is more than 60,000 australes (which

3. For compulsory loan purposes, the 1984 income tax paid is deductible in computing the net wealth taxable base, whereas property which was exempt from net wealth tax in 1984 (e.g. fixed term deposits – in local or foreign currency – with Argentine banks and qualifying securities) must be included in such taxable base.

4. Law 23,297 of 31 October 1985 has eliminated all former exemptions from net wealth tax (with the only exception for Treasury and other qualifying central and local government bonds) with effect as from 31 December 1985. The net wealth tax (whose application ended on 31 December 1985) has been extended to 31 December 1995 by Law 23,285 of 30 October 1985.

is the tax-free limit for 1985), then the net wealth tax liability for compulsory loan purposes is assessed in accordance with the progressive rates indicated in Table III.[5]

The net worth tax liability for corporate compulsory loan purposes is assessed at 1.5% of the equity capital of the company, permanent establishment, or individual firm concerned.

The resulting tax liability in pesos, in respect of the net wealth/worth for 1984, must also be adjusted (multiplying it by the 5.58 coefficient referred to above) and the balance, converted into australes, is the taxable capacity in respect of net wealth/worth. The amount of the loan in respect of net wealth/worth is 40% of such taxable capacity for individuals and 30% for corporate taxpayers and firms (which is the savings capacity).

5. This new net wealth tax rates table (in australes) was introduced by Law 23,297 of 31 October 1985.

Table II
Net wealth tax table
(For compulsory loan purposes) for 1984

Taxable net wealth brackets (in pesos)	*Tax due on lower limit (in pesos)*	*Tax rate on the excess over lower limit (in %)*
— - 11,237,426	—	nil
11,237,427 - 44,949,707	nil	0.5
44,949,708 - 67,424,560	168,561	0.75
67,424,561 - 89,899,414	337,122	1
89,899,415 - 134,849,120	561,871	1.25
134,849,121 - —	1,123,742	1.5

Table III
Net wealth tax table for 1985

Taxable net wealth brackets (in australes)	*Tax due on lower limit (in australes)*	*Tax rate on the excess over lower limit (in %)*
— - 60,000	—	nil
60,001 - 90,000	nil	0.5
90,001 - 135,000	150	0.75
135,001 - 200,000	487.5	1
200,001 - 300,000	1,137.5	1.25
300,001 - 450,000	2,387.5	1.5
450,001 - 675,000	4,637.5	1.75
675,001 - —	8,575	2

E. ILLUSTRATIVE EXAMPLES ON CALCULATION OF THE COMPULSORY LOAN

(1) Resident company and permanent establishment

The compulsory (savings) loan for a resident subsidiary corporation and a permanent establishment of a foreign entrepreneur can be quite substantial. Assuming that for compulsory loan purposes the taxable profits of a subsidiary and permanent establishment is 100,000,000 pesos and their taxable net worth is 500,000,000 pesos, the amount to be saved (lent to the Government) in respect of their taxable capacity for 1984 would be 90,396 australes (1 US$ = 0.80 austral) for the subsidiary and 117,180 australes for the permanent establishment, in accordance with the calculation in Table A.

(2) Resident individual taxpayers

A. Assuming that a resident individual declared, in his income tax return for 1984, 10,000,000 pesos taxable income and 800,000 pesos exempt income and was entitled to the deductible allowances indicated in the example below, the amount to be lent to the Government in respect of his income tax capacity for 1984 would be 6,979.37 australes in accordance with the calculation in Table B.

B. Assuming that the same taxpayer, as referred to in A. above, declared in his net wealth tax return for 1984 250,000,000 pesos and, as exempt property, 10,500,000 (fixed term deposit), the amount to be lent to the Government in respect of his net wealth tax capacity for 1984 would be 7,062.21 australes in accordance with the calculation in Table C.

TABLE A

	Income tax (in pesos)	Adjusted amount of income tax (in pesos)	Taxable income capacity (in australes)	Net worth tax (in pesos)	Adjusted amount of net worth tax (in pesos)	Taxable net worth capacity (in australes)	Combined taxable capacity (in australes)	Amount of the loan (in australes)*
Subsidiary	33,000,000	184,140,000	184,140	7,500,000	41,850,000	41,850	225,990	67,797
Permanent establishment	45,000,000	251,100,000	251,100	7,500,000	41,850,000	41,850	292,950	87,885

* Where such subsidiary or permanent establishment lost in 1985, e.g., 25% of their 1984 income-generating capital, the amount of the compulsory loan would be reduced by 16,949.25 and 21,971.25 respectively (i.e. 25% of 30% of 225,990 and 292,950 australes respectively).

TABLE B

Taxable income 1984	Deductible allowances	Taxable base	Tax due	Taxable income for compulsory loan purposes	Tax liability for compulsory loan purposes (i.e. taxable income capacity): In pesos	Adjusted amount	In australes	Compulsory loan based on income capacity 1984
10,000,000	1,618,400[1]	8,381,600	2,640,984[2]	9,461,548[3]	3,126,960[4]	17,448,436[5]	17,448.43	6,979.37[6]

1. i.e. (a) medical insurance: 100,000 (assumed cost)
   (b) life insurance: 100,000 (assumed cost)
   (c) special on earned income: 559,896
   (d) tax-free income: 497,676
   (e) spouse: 155,532
   (f) 2 children: 205,296
2. I.e. 1,813,319 on first 6,542,345 + 827,665 on the excess (i.e. 45% of 1,839,255).
3. I.e. taxable income 1984 + 800,000 exempt income + 50% of the special allowance on earned income (i.e., of 559,896).
4. I.e. 1,813,319 on first 6,542,245 + 1,313,641 on the excess (i.e. 45% of 2,919,203).
5. I.e. taxable income capacity in pesos x 5.58 coefficient of variation in the general wholesale price index.
6. I.e. 40% of the 1984 income tax capacity.

TABLE C

Taxable net wealth 1984	Deductible income tax due 1984	Taxable net wealth for compulsory loan purposes	Tax liability for compulsory loan purposes (i.e. taxable net wealth capacity): In pesos	Ajusted amount	In australes	Compulsory loan based on net wealth capacity 1984
250,000,000[1]	2,640,984[2]	262,859,016[3]	3,143,891[4]	17,542,911[5]	17,542.91	7,017.16[6]

1. I.e. excluding inter alia: fixed term deposits in Argentina, securities issued by Argentine central and local governments, corporate bonds/debentures issued at less than 3 years maturity which are treated as exempt property for net wealth tax purposes. However, Law 23,297 of 31 October 1985 has eliminated most of these exemptions, remaining applicable (as of 31 December 1985) only to Treasury and other public bonds.
2. I.e. the amount of income tax liability for 1984.
3. I.e. the amount of taxable net wealth (less income tax) + 10,500,000 (fixed term deposit).
4. I.e. 1,123,742 on first 134,849,120 + 2,020,149 on the excess (i.e. 1.5% of 128,009,896).
5. I.e. taxable net wealth capacity in pesos x 5.58 coefficient of variation in the general wholesale price index.
6. I.e. 40% of the 1984 taxable net wealth capacity.

The first compulsory loan installment of such taxpayer (in respect of his income tax and net wealth tax capacity 1984) would be 13,996.53 australes. But if he lost in 1985, e.g., 25% of his income-generating capital, then his loan would be reduced by 3,499.13 australes (i.e., 25% of 40% of 34,991.34).

INTERNATIONAL FISCAL ASSOCIATION NEWS

INTERPRETATION OF TAX TREATIES*

INTRODUCTION

This report summarises the panel discussion of Seminar B at the IFA Congress in London held on 11 September 1985. The basis of the seminar was an article published in the British Tax Review for 1984 starting at pages 14 and 90. The objective was to ask one of the authors of that article, David Ward Q.C. of Toronto, to put forward the ideas in the article in the question of which State's internal law is to be applied under Article 3(2) of the OECD Model, referring to the internal law meaning of undefined expressions, the text of which is set out below, and the related issue of whether later changes in internal law are to be applied; and for these to be criticised by the other members of the panel, comprising Sir Ian Sinclair K.C.M.G. Q.C., former Legal Adviser to the U.K. Foreign Office, who would comment from the general public international law point of view, Professor Klaus Vogel, professor of public law at the University of Munich, and Kees van Raad, University of Leiden, the Netherlands. The Chairman was John Avery Jones.

I. CONFLICTS CAUSED BY REFERENCE TO INTERNAL LAW

Sir Ian Sinclair:

I must begin, particularly in the presence of such an august and well informed audience, by making a disclaimer. I know virtually nothing about double taxation conventions. My professional experience in the Legal Branch of the U.K. Diplomatic Service (where I served for 34 years) and, more recently, in private practice, has not required me to consider the particular problems that may arise in connection with the interpretation and application of tax treaties. It has of course inevitably involved me from time to time (indeed, when I was serving in the Foreign and Commonwealth Office, almost on a day to day basis) with giving advice on the interpretation of international treaties in general, whether they be multilateral conventions or purely bilateral agreements and whatever might be their subject matter. I was indeed somewhat reticent when John Avery Jones approached me and suggested that I might be able to make a contribution to this seminar. I pleaded my lack of expertise in the particular subject matter. But it was represented to me that I might be able to make some observations on treaty interpretation in general which could be relevant to the particular problems which are the subject matter of this seminar. Hence may presence this afternoon.

I would therefore propose to address three separate but related questions:

(1) to what extent are the principles of interpretation elaborated in the *Vienna Convention on the Law of Treaties* relevant to the interpretation of tax treaties?
(3) does Article 3(2) of the OECD Model make reference to those principles of interpretation less relevant?
(3) what is the significance of the principle of contemporaneity in the context of determining whether a static or ambulatory meaning should be given to the provisions of internal law? This will be considered in the second part.

The first question is relatively easy to answer. There can be no doubt that the Vienna Convention on the Law of Treaties was intended to cover all types of international agreements between States, that is to say all agreements concluded between States in writing and governed by international law, whatever their designation and whether embodied in a single instrument or in two or more instruments. In principle, therefore, tax treaties fall within the scope of the Vienna Convention and the principles of treaty interpretation elaborated in the Convention are as applicable to tax treaties as they are to other categories of treaty, such as extradition treaties, treaties for the enforcement of judgments, commercial treaties, treaties relating to territorial status, human rights treaties, etc. There is no particular category of treaty which is excluded from the general scope of the definition of the term "treaty" in Article 2 of the Vienna Convention. It is important to add that the principles of treaty interpretation embodied in the Vienna Convention are now regarded as forming part of the corpus of customary international law and are, therefore, applicable not only as between States parties to the Vienna Convention, but also as between non-parties. In the *Young Loan* case the Arbitral Tribunal for the agreement on German External Debts has expressed the view that ". . . the [Vienna] Convention properly reflects both the present and the past state of international law since, as regards in-

* This transcript was prepared by Mr. John John Avery Jones, Chairman of the Seminar.

terpretation at least, it is restricted to the codification of customary judgment of the European Court of Human Rights in the *Golder* case and in the award of the Court of Arbitration in the *Beagle Channel* case between Argentina and Chile. In the very recent arbitration between Guinea and *Guinea-Bissau* on the delineation of their maritime boundary, the Court of Arbitration had no hesitation in applying the rules stated in Articles 31 and 32 of the Vienna Convention to the interpretation of a convention of 1886.

This having been said, it would be wrong to regard the principles of interpretation contained in Articles 31 to 33 of the Vienna Convention as amounting to anything more than general guidelines. O'Connell has commented that "the priorities inherent in the application of these rules are not clearly indicated, and the rules themselves are in part so general that it is necessary to review traditional methods whenever interpreting a treaty". The criticism of the generality of the rules is no doubt cogent. But it fails to take into account the consideration that the International Law Commission, whose proposed formulations of the rules on interpretation were incorporated virtually without change into the Vienna Convention, had already disavowed any intent to produce a comprehensive code of canons of treaty interpretation. The Commission in their commentary to what has now become Articles 31 and 32 of the Vienna Convention, refer to the rich variety of principles and maxims of interpretation applied by international tribunals. They go on to point out that these are, for the most part, principles of logic and good sense which are valuable only as guides to assist in appreciating the meaning which the parties may have intended to attach to the expressions employed in a document; and the recourse to many of these principles is discretionary rather than obligatory, interpretation being to some extent an art rather than an exact science. The Commission accordingly concluded that "any attempt to codify the conditions of the application of those principles of interpretation whose appropriateness in any given case depends on the particular context and on a subjective appreciation of varying circumstances would clearly be inadvisable".

So we are left with a very economical and self-confessedly incomplete set of guidelines. The general rule of interpretation is stated in Article 31(1) of the Vienna Convention:

> 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.

Note that this general rule places firm emphasis on the *text* of the treaty as an authentic expression of the intentions of the parties. This is broadly consistent with the view of the late Lord McNair, a former President of the International Court of Justice, who suggested that the main task involved in the process of interpretation is to give effect to the *expressed* intention of the parties, that is to say, "their intention as expressed in the words used by them in the light of the surrounding circumstances".

We then have, in Article 31(2) a fairly narrow definition of the term "context". It is stated to comprise, in addition to the text of the treaty, including its preamble and annexes, (a) any agreement relating to the treaty made between the parties in connection with the conclusion of the treaty and (b) any instrument made by one or more parties in connection with the conclusion of the treaty and acepted by the parties as an instrument related to the treaty. The text and context as so defined constitute what Charles de Vischer describes as the "intrinsic" elements of interpretation as opposed to the "extrinsic" elements to which we now turn.

Article 31(3) requires that there should also be taken into acount, together with the context:

> (a) any subsequent agreement between the parties regarding the interpretation of the treaty or the application of its provisions;
> (b) any subsequent practice between the parties regarding the interpretation of the treaty or the application of its provisions;
> (c) any relevant rules of international law applicable in relations between the parties.

I will have more the say in the second part about the requirements that any relevant rules of international law applicable in the relations between the parties should also be taken into account.

Finally, Article 31(4) provides that a special meaning, as contrasted with the ordinary meaning, should be given to a term if it is established that the parties so intended. There are a few examples in international jurisprudence of a "special meaning" being given to a term, notably in the award in the *U.K./France Continental Shelf* where a wider meaning was given to the geographical expression "Bay of Granville" (used in a French annotation) than the ordinary meaning might have suggested. However, the burden of proof of a special meaning lies on the party advancing it and it is rare for an international tribunal to adopt a special meaning, particularly if it can give effect to a provision of the treaty by giving to the words used their natural and ordinary meaning.

I will skate lightly over the remaining Vienna Convention rules on interpretation. Article 32 deals with supplementary means of interpretation, including the preparatory work of the treaty and the circumstances of its conclusion, and stipulates that recourse may be had to such means in order to confirm the meaning resulting from the application of Article 31 or to determine the meaning when the interpretation according to Article 31 leaves the meaning ambiguous or obscure or leads to a result which is manifestly absurd or unreasonable. I would only comment that, in practice, extensive recourse to *travaux prêparatoires* of a treaty will be nevertheless in the context of any dispute about treaty interpretation since, almost by definition, any disputes about the interpretation of a treaty provision which reaches the stage of international adjudication will have arisen because the text is ambiguous or obscure. In practice, therefore, international tribunals are regularly called upon to assess the significance of *travaux préparatoires*. The difficulty is of course that the *travaux* themselves (even when they are available, which is highly unlikely in the case of a recent bilateral treaty where the negotiations will no doubt have been conducted on a confidential basis) are unlikely to reveal accurately and in detail what happened during the negotiations and are therefore not as apt to resolve any ambiguity in the text as first appearances might suggest. Article 33 deals with the interpretation of plurilingual treaties, but I will refrain for reasons of economy from analysing its context.

This then, is a very rough and general sketch of the content of the Vienna Convention rules of treaty interpretation. To revert to the second of the two questions to which I addressed myself at the outset, does Article 3(2) of the OECD Model make reference to those ideas less relevant? I would suggest not. Article 3(2) of the OECD Model is itself a treaty text and falls to be interpreted in accordance with the Vienna Convention rules. There is no evidence in the text of Article 3(2) itself, nor to the best of my knowledge, in the Commentaries to the OECD Model, to suggest otherwise.

What then of Article 3(2) of the OECD Model itself – and here I refer to the 1977 version? First, let us see what Article 3(2) of the OECD Model actually says. Its sense can, I think, be paraphrased as follows: a Contracting State applying the Convention shall, unless the context otherwise requires, give to any term not defined in the Convention the meaning which it has under the internal law of the State concerning the taxes to which the Convention applies. If this is indeed the sense of Article 3(2) it would seem to indicate an intent on the part of the drafters of the OECD Model to permit (indeed to require) references to internal law to elucidate the meaning of the terms not defined in the Convention. This is not in the least surprising since at least as I understand the position, the object and purpose of a bilateral tax treaty is not to unify or harmonise the laws of the two States concerned; it is rather to provide relief from tax in that State which would or might otherwise charge it. There is therefore an intimate connection between the relieving provisions and the charging provisions of internal law, and it makes sense to refer the meaning of undefined terms in a tax treaty to the internal law of the State concerned. I do not regard this process as amounting to the giving of a special meaning to a term in the sense of Article 31(4) of the Vienna Convention rules. Article 3(2) of the OECD Model is essentially procedural or referential in nature. A particular meaning of a term may result from the application of the meaning under internal law, as required by Article 3(2) of the OECD Model itself. Indeed, it is the "ordinary meaning" of Article 3(2) in its context and in the light and object and purposes of the tax treaty which produces the conclusion that the meaning of undefined terms must, unless the context otherwise requires, be referred to the appropriate internal law.

This is not to say that the meaning of Article 3(2) of the OECD Model is clear. Indeed there are notable gaps and obscurities in the wording. This is particularly true of the expressions "any term not defined therein" and "unless the context otherwise requires".

David Ward:

Article 3(2) states that:

> As regards the application of the Convention by a Contracting State any term not defined therein shall, *unless the context otherwise requires*, have the meaning which it has under the law *of that State* concerning the taxes to which the convention applies. [Emphasis added]

In applying Article 3(2) various questions arise: what is the result if, under internal law, a particular payment classifies differently in each State? How can the differences be reconciled? In particular, in the context of Article 23 (the credit/exemption article) how is the difference in characterisation to be reconciled?

The relevant portions of Articles 23A (credit) and 23B (exemption) state that: "Where a resident of a Contracting State derives income or owns capital which, in accordance with the provisions of this Convention may be taxed in the other Contracting State. . ." then the first mentioned State shall exempt such income from tax (in an exemption State) or shall allow a credit for the tax (in a credit State).

The recent *Pierre Boulez* case, 83 TC No. 131, decided by the U.S. Tax Court provides a good example of these difficulties which arose in the context of the Germany-U.S. treaty of 1954. Taxpayer Boulez, the famous conductor, while a resident of Germany, made a contract with CBS records in the U.S. to conduct certain musical performances for the purpose of making phonograph records. The agreement provided: "for your services . . . and the rights granted herein . . . we will pay you the following royalties . . . ." which were then spelled out. The agreement provided, however, that all property rights in the master recordings belonged at all times to CBS and Boulez obtained no rights in the nature of copyright in the recordings.

The United States Revenue Service claimed tax on the payments made to Boulez on the basis that they were "compensation for personal services" rendered in the U.S. which the U.S. had the right to tax, and not royalties, which the U.S. had no right to tax.

It should be noted that the Boulez case is not in one sense an Article 3(2) case because the term "royalties" is defined in the German-U.S. treaty as:

> any royalties, rentals or other amounts paid as consideration for the use of, or the right to use, copyrights, artistic or scientific works, patents . . . or other like properties or rights. . . .

In another sense, however, it is an Article 3(2) case because it also involved the interpretation of the phrase "compensation for the personal services", which was not defined in the treaty.

The U.S. tax court upheld the position of the IRS, holding that because Boulez never had a copyright or other property interest in the musical works, the amounts paid to him, although described as "royalties" in the agreement with CBS, were really compensation for personal services and therefore subject to tax under the treaty.

The relevant exemption provision of the German-U.S. treaty stated that ". . . income from sources within the United States which, *according to this Convention* is not exempt from United States tax" . . . shall be excluded from the basis upon which the Federal Republic tax is imposed.

Germany, however, took the position that, from a German point of view, the payments were clearly royalties which the United States should not have taxed and therefore Germany would not apply the equivalent of Article 23 of the treaty to exempt the payments.

It is suggested that if the *Boulez* case is considered an Article 3(2) case – which let us presume, without agreeing that it is – then Germany should not have applied its internal law in determining whether the United States had a right to "tax acccording to the Convention" (i.e., by applying Article 3(2)) in referring to its internal law concepts to characterise the payments. It should recognise the United States' right to "tax according to the Convention" (i.e., by applying Article 3(2) by reference to its internal law definitions. If this view had been taken – which I suggest is the correct one if this had been an Article 3(2) case – double taxation would be avoided.

It is also suggested that on this view of the interpretation of Article 23, whether it be a credit or exemption provision, double taxation should be avoided consistently without resort to mutual agreement proceedings (which for Boulez were unsuccessful) even where the two States, if they used their own internal law definitions, would classify the payments differently.

Turning to the obverse question – double non-taxation – which bothers Revenue authorities and academics a bit more than taxpayers and their advisers – let us see how this thesis of the application of Article 3(2) with Article 23 operates. If the State of residence is a credit State and brings all foreign source income into the taxable income calculation, non-taxation cannot occur. If the State of residence is an exemption State and characterises the payment by its internal law as one which the treaty permits only the source State to tax, double non-taxation could arise if the source State characterises the payment as one which only the State of residence may tax. However, in such a case, the double non-taxation seems to be a result of the failure of the State of residence to impose tax by its internal law, *irrespective* of the treaty. Again, Article 23 exempts income from tax in the State of residence where ". . . in accordance with the provisions of this Convention [it] may be taxed in the other State. . .". If the State of residence recognises, as it is submitted it must, the correctness of the application of the source State's internal law definition in establishing the right of the source State to tax, then it should not exempt the payment from tax in the State of residence.

Professor Klaus Vogel:

David Ward's solution rather appeals to me and I do not doubt that it would be feasible. I am afraid however that there is little, if any, likelihood that tax authorities or courts would adopt his solution. In this respect, his solution seems to me to be more idealistic than practical.

To explain this I must ask your permission to begin a few steps further back. The problem raised by Article 3(2) predates that article and its antecedents. The first German cases relating to that problem go back as far as 1934; I suppose the same would be true in other countries. Moreover, even today the problem can arise as well in situations to which Article 3(2) does not apply. For example, if a treaty term is not defined in both States "under the law . . . concerning the taxes to which the Convention applies", but, let us assume, under their commercial law, should a court construe that term according to its own internal commercial law, according to the commercial law of the other State, or according to some other standard?

In discussing this problem, which has been said to be analogous to the problem of "qualification" in private international law – a discussion which began in Germany, as I mentioned, as early as the mid-thirties – three basic positions have been advanced.

At first glance it seems most natural to a court or tax administration to apply its internal law. This solution, indeed, is usually adopted in practice. If both states adopt it however, this solution, as David Ward points out, can lead to consequences that are not desirable in terms of tax equity. Let me illustrate this by referring to a case decided by the German Federal Tax Court (Bundesfinanzhof). On termination of employment of a manager who was resident in Switzerland, a German GmbH paid a golden handshake. Under German law this payment was (and is) treated as income from dependent personal services within Article 15 of the OECD Model Convention. So, Germany being the country where the work had been performed, the Federal Tax Court, according to Article 15 – more precisely, according to the corresponding provision of the Swiss-German treaty of 1931 – held the payment to be taxable in Germany. In Switzerland, on the other hand, the golden handshake was treated at that time as "other income" covered under Article 21 of the Model Convention, taxable only in the State of residence. (Today the law of the Swiss Cantons has been altered to provide that a golden handshake constitutes other income only if it is not subject to taxation at source.) Thus, Switzerland, construing the terms of the treaty according to its internal law, taxed the golden handshake as well. Consequently, double taxation was not avoided and the purpose of the treaty was not fulfilled.

Had the GmbH been a Swiss company and the manager a resident of Germany, Switzerland, treating the golden handshake as other income and, therefore, as taxable in Germany, would have refrained from taxing it, and Germany treating it as income from personal services and, therefore, as taxable in Switzerland would have refrained from taxing it too. The result in this reverse case would have been, in other words, double non-taxation.

To avoid these consequences, it has been suggested repeatedly that the State of residence should adopt the source State's qualification. This is the solution advocated by David Ward. The German *Reichsfinanzhof* followed this rule in its first case in point in 1934. However, this case was overruled by the same court in 1938 and since that time the German courts have consistently construed treaty terms according to German internal law. Qualification according to the law of the source State would indeed avoid double non-taxation, but the awkward consequence of this rule is that the State whose internal law attributes the broader definition to the term in question always would have an advantage. Let us consider the case of the golden handshake again. If we apply David Ward's solution to the original case, Germany as the source country would be entitled to apply its internal qualification and to tax the income in question, whereas Switzerland would be obliged to follow the German qualification and to refrain from taxation. There seems to be nothing wrong with the solution. However, if we consider the reverse case involving the Swiss GmbH with a manager resident in Germany and consequently applying the Swiss qualification, we find that again the right to tax the proceeds will fall to Germany. I doubt whether Swiss courts would be inclined to accept this result.

In may opinion, there are two reasons to reject this rule. First, states could abuse it by deliberately extending certain of their internal law definitions. This, of course, presupposes that the reference to internal law in the treaty is ambulatory, rather than static, which is to be discussed later. However, I want to emphasise that independent of the static v. ambulatory interpretation issue, the rule seems to me unacceptable because its results are necessarily unbalanced and discriminatory. In addition, from a practical point of view, I doubt whether it would be possible to convince the administrative authorities and courts to adopt such a rule, administrative authorities and courts to adopt such a rule, especially the authorities and courts of the State which, given a case, would be disadvantaged.

To overcome this dilemma it has been suggested that treaty terms always should be interpreted autonomously, without reference to the internal law of any Contracting State. This is certainly an ideal solution, a most international one, but unfortunately very often not a feasible one. For example, how can we derive from a treaty anything helpful in deciding whether a golden handshake represents personal service or other income? Thus we simply cannot get along without reference to internal law at least to some extent; this is why Article 3(2) has been adopted. If my assessment of David Ward's solution is correct and it has no real chance of being adopted, then we shall help taxpayers best by accepting qualification according to internal law in both countries, as a last resort, while making every effort on the other hand to find an autonomous qualification wherever possible.

In conclusion, I want to comment briefly on one technical argument advanced by David Ward. He relies strongly on the language of Article 23 of the Model Convention which states "income . . . which in accordance with the provisions of the Convention may be taxed . . .". I do not think this argument is conclusive, if only because Article 23 does not apply to all situations in which Article 3(2) is relevant. The OECD Model has adopted specific language according to which some of the rules of Chapters III and IV (the rules dividing taxation between Contracting States, or "distributive rules", in German *Verteilungsnormen*) provide that a given item "shall be taxable only" in a Contracting State. Where the Model provides that an item "shall be taxable only" in a Contracting State, that item is exempt from taxation in the other Contracting State, even if that other State is a credit State. With regard to these rules, Article 23 does not apply. The State in which items are exempt usually is the source State, but in some cases it is the State of residence. The OECD Commentary mentions four such cases (*see* Art. 23, Comm. no. 6, note 2). Even the U.S. Treasury Model, in spite of its saving clause, provides to some extent for exemption in the residence State (*see* Article 1(4)(a)(b) and Article 18, 19 Treasury Model). Because Article 23 does not apply in these cases it says nothing regarding questions of qualification in this context.

Kees van Raad:

If two States enter into the negotiation of a tax treaty, one may safely assume that they both intend to solve, through the treaty, the double taxation problems that may arise between the two of them. That is, problems of what we call *juridical* international double taxation. This notion is discussed in the OECD Commentary on Article 23. It deals with one taxpayer who is subject to tax on a given item of income in two States. In order to prevent the two States involved from both taxing the same item of income, the treaty will assign that income to one of the States. But for that it is necessary that the two States attach the same label, the same characterisation, to the given item of income. An entirely different problem occurs when the two States take different views on *who is the taxpayer* in respect of a given item of income. That concerns economic double taxation. Take for example a closely held corporation. The State of which the corporation is a resident may consider the corporation to be the taxpayer for any profits generated by the business activities carried on. But if the shareholders reside in another State, that State may consider the corporation transparent and tax the shareholders directly for the profits. For this problem of *who* should be treated as recipient of a given item of income, treaties offer no general solution.

But going back to any differences between States on how to classify a given type of income, I repeat that one may assume that if such a difference was known to the treaty States at the time they were still negotiating the treaty, they most likely would have dealt with the issue and agreed on a solution.

The situation we are discussing today is what to do if a difference in classification of a given item of income between the two treaty States was apparently *not* noticed when the treaty was negotiated, like the difference that showed up in the case of *Pierre Boulez.*

If a treaty uses a certain expression and this expression is defined somewhere in the treaty, both parties are required under Article 3(2) to interpret this term in accordance with that definition.

In absence of a treaty definition, Article 3(2) necessitates the establishment of the meaning of the term both under the internal law of the treaty States and under the treaty context. If it appears that there is a important difference between the internal and the contextual meanings, Article 3(2) gives priority to the meaning which flows from the context.

When I say the meaning of a term under the internal law of the treaty States, the question is: the internal law of *which* treaty State. As you have heard from the other speakers on this Panel, it is often understood that when an item of income is assigned by treaty to the source State and the residence State is obliged to given an exemption or a tax credit, each of the two States will consider itself "applying the treaty" and refer to its own internal law. Depending on the facts of the case and the treaty provisions concerned, this may sometimes produce double taxation and sometimes lead to no taxation at all. This is the reason for the authors of the BTR article looking for another solution: characterisation of a given item of income on the basis of the internal law of the *source* state. In this solution *double taxation* is prevented; in the case that *neither* of the two States involved imposes any tax, this is not directly caused by the treaty but by the fact that the State to which the income has been assigned, does not tax it under internal law. This is a phenomenon which is quite common when a State applies a treaty, particularly where it concerns a State employing the exemption system. Professor Vogel has pointed out, however, that if it is up to the source State's law to determine by which treaty provisions a given item of income is covered, it will always be the *same State* which, in a given factual situation, ends up with the right to tax.

Let me give your another example to illustrate his point. I first explain the traditional point of view in which both States interpret a treaty on the basis of their own internal law. Let us assume that under Dutch law a limited partner in a limited partnership receives investment income, which under the treaty in the Dutch view does not qualify as dividends or interest but as "other income". If a Dutch individual is a partner in a German limited partnership which derives its income entirely from German sources, the income of the Dutch individual from the limited partnership will qualify from a Dutch perspective as "other income" (Article 21 OECD Model), assigned to the residence State of the individual: Holland. If Germany, on the contrary, treats the Dutch limited partner as a person who earns business income through a German permanent establishment, Germany will apply Article 7 and will read the treaty as assigning the Dutch limited partner's income to the source State, that is Germany. This is what would happen under the traditional application of Article 3(2).

Now, if both States would adhere to the characterisation of the income by the source State, the following would happen. The source State (Germany) classifies the income as business income. Consequently, the residence State (Holland) must stick to the German classification and, under Article 7, leave it up to Germany as the p.e. State to tax the limited partner's income. Germany, as source State, can apply the classification of the income under its own internal law and tax the Dutch resident for the business income. Holland would tax the resident partner on his income and give an exemption for the business profits as foreign permanent establishment income.

Let us now reverse the facts: a German resident is a limited partner in a partnership that operates exclusively in Holland. Now the internal law of Holland, the source country, controls the nature of the limited partner's income: investment income, covered by Article 21 OECD. The Article assigns the income to the residence State: Germany again.

Professor Vogel considers this double assignment to Germany incompatible with the object of the treaty to distribute taxes in an equitable way between the Contracting States. I tend to disagree with him. In respect of a different factual situation where the Dutch characterisation (and its treaty consequences for Holland) differs from the German interpretation the odds may be in favour of Holland.

In cases where Article 3(2) refers to internal law, the question is, if (a) the current practice to permit both States to interpret the treaty on the basis of their own law, should be stopped because it may easily produce either double or no taxation, and (b) binding interpretation on the basis of the law of the source State is considered to be inequitable to the States involved, what other apprach could one take?

Interpretation on the basis of the law of the *residence State* has been mentioned in legal writings as a possibility. The first problem with such method appears to be that the present language of Article 3(2) does not permit it. The provision refers to the *application of the Convention by a Contracting State.* Any lawyer who interprets this language as covering the residence State without at the same time covering the source State would in my opinion not render an independent service as referred to in Article 14 of the OECD Model. Such lawyer certainly would seem to lack a fixed base for this interpretation. Another problem with interpreting on the basis of the law of the residence State would be that it produces exactly the same peculiar results as Professor Vogel does not appreciate when the source State's interpretation is binding for the residence State: if in a given factual situation source State and residence State are reversed, it is still the same State that is going to end up with the right to tax. I am not going to try to give an example of that but I take it that you believe me.

Then there is the autonomous approach. That is, within the framework of Article 3(2), an interpretation on the basis of the treaty context. The immediate question here is, of course, what the scope is of the term "context". As this is a term which is used in Article 3(2), it cannot be interpreted by Article 3(2) itself. This is one of the two instances – I refer to interpreting the interpretation rule itself – where the Vienna Convention on the Law of Treaties comes into play in OECD-type tax treaties, particularly Articles 31 and 32 of that Convention provide that a *treaty shall be interpreted* in good faith in accordeance 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 purpose of the treaty is to avoid double taxation. So if the traditional approach of having each Contracting State interpret an undefined treaty term on the basis of its own law without taking into account the meaning under the other State's law, if this traditional approach produces double taxation, the question is whether one could say that in such case the interpretation under internal law is clearly in conflict with the treaty's context, because this context aims at avoiding double taxation. If this is an acceptable proposition, the next question of course is what the meaning is that flows from this context. And there one will often find oneself stuck. I refer to the problem of qualifying the income of a limited partner. I also refer to the question presented in the case of *Pierre Boulez*. Very likely the context will say very little on these rather technical points. I should make one exception. In quite a few instances the OECD Commentary will go beyond just explaining the text of the OECD Model. In adddition it may say something for which a direct basis in the text of the Model itself is missing. If one takes the OECD Commentary to be part of the context of an actual treaty, to the extent this treaty follows the OECD Model, those additional statements in the Commentary will be clarifying and, consequently, the context will be important. But then another problem may arise; the treaty country whose internal law happens to be not in conformity with the OECD Commentary, may not accept this Commentary as part of the actual treaty's context and then the perspective of uniform interpretation becomes dim again.

So in may opinion the practical possibilities of the treaty context and consequently of the autonomous approach are limited. This brings one back to the law of Contracting States. Given the choice between application by each State of its own law and application by both States of the source country's law, I am inclined to opt for the latter, that is: interpretation on the basis of the law of the source State as the best among imperfect solutions.

One may wonder whether there are any workable alternatives to Article 3(2). E.g., would it be possible to provide that, in the case where the internal law meanings in the two States are in conflict, the numerical order of the articles in the treaty determines the priority. That is if one State treats a given item of income under treaty Article 10 and the other State lists it under Article 7, the latter State's definition would control. Or one may, specifically for this purpose, include in treaties a list of income types in binding order of priority. Neither of these two approaches, however, appears to provide any advantage over giving control to the meaning of a term established under the law of the source State.

Alternatively, one may think of establishing something like a world tax court. This suggestion has often been made in the past, but the political reality appears to be that States are unwilling to give up much of their sovereignty in matters of taxation. If one looks at the fate of the EEC Draft Directive on Arbitration, whose scope is even limited to double taxation in transfer pricing between associated enterprises: this Draft directive has been sitting on the shelf since 1976. On the other hand I am much interested in the experience of the Nordic countries (Norway, Sweden, Denmark, Finland and Iceland) with their multilateral double taxation convention of 1983. If I am informed correctly, the mutual agreement article of this treaty provides that, before the competent authorities of two States take a decision in a mutual agreement procedure, they communicate the result of their consultations as soon as possible to the competent authorities of the other Nordic states. I understand that, if the competent authority of any of these states, learning about the result, is of the opinion that the authorities of all States should consult together, such consultations are organized immediately.

Conclusion

The Chairman concluded by agreeing with Kees van Raad that the alternatives which where theoretically better, such as trying to find an autonomous solution or having a world tax court, were unlikely to be of much practical use, at least in the short term, and there was a considerable degree of support for David Ward's solution, Professor Vogel's objection being more on whether it would be adopted, rather than whether it would work. He expressed the hope that the OECD would spell out how Article 3(2) was intended to operate, in view of the considerable uncertainty which obviously existed on a topic of such fundamental importance.

II. THE STATIC/AMBULATORY ISSUE

The Chairman introduced the topic by asking whether, having perhaps ascertained which State's internal law was being referred to, the reference was to internal law at the date of the treaty or the internal law from time to time in force. As David Ward points out this is quite a different question from whether later internal law can override a treaty. Suppose Article 3(2) had actually referred to internal law from time to time in force it would be clear that the negotiators contemplated changes being taken into account in interpreting the treaty. Surprisingly there seems little authority on this question anywhere in the world, except in Canada in a case which David Ward considers right for the wrong reason. The article referred to above collects the views of a number of States on this question and there seems a general preference for an ambulatory interpretation. This was confirmed by the views of the panel. But if this is the case, there must be some limit to what changes to internal law apply for treaty purposes. A speaker from the floor instanced a change defining capital gains to include income from employment which clearly goes too far.

David Ward:

I suggest that there is nothing unbalanced in the concept that the treaty negotiators be presumed to know what they are doing in accepting, through Article 3(2), each other's internal law definitions of undefined terms used in the treaty. However, this section of our discussion introduces the important question: where Article 3(2) applies, is the reference to internal law the law as it stood when the treaty was made, or is the reference to the law as it may be amended from time time? This is the so called static/ambulatory issue.

The issue is a real one, which recently came before the Supreme Court of Canada in the *Melford Developments Inc.* case in 1982. The case involved the Canada-Germany Treaty of 1956, which more or less followed what subsequently became the OECD pattern. The treaty contained a couterpart of Article 3(2). The treaty, however, provided no definition of the term interest (as appears in Article 11(3) of the Model). The issue involved Canada's rights to tax a guarantee fee paid by a Canadian resident to a German bank that had no permanent establishment in Canada. The characterisation issue was whether the payment constituted "business profits" of the German bank (which Canada could not tax) or "interest" (which it could). The Canadian Revenue claimed that by virtue of the counterpart of Article 3(2) the payment was interest because it was deemed to be interest because of a 1976 amendment to Canada's Income Tax Act which deems such guarantee fees to be interest.

The Court disagreed with the Revenue, finding Article 3(2) to be static, fixing definitions found in internal law to those in force at the time the treaty was made. This conclusion has not had wide acceptance internationally although it does adequately limit a State from unilaterally expanding its taxing power by cleverly worded statutory amendments by which it may deem payments which would otherwise be exempt, to be characterised as payments which it has the power to tax.

Canada reacted to the *Melford* case in the only way it could to reverse a Supreme Court case – by legislation. The Income Tax Conventions Interpretation Act, which recently became law in Canada, provides that an ambulatory and not a static interpretation of undefined or partially defined treaty terms is to be given to the Courts. In so doing, the Government has said that such an interpretation is consistent with the intentions of Canada's treaty partners.

If that is so, then, because of Canada's large number of treaties, it must follow that treaty negotiators are in general agreement that Article 3(2) is *intended* to permit States to redefine treaty terms from time to time, thereby altering the application of the treaty. It is suggested that it is incorrect, as some commentators have claimed, that such amendments to internal law will amend the treaty. On my view, if the treaty negotiators intended internal law definitions to be flexible, then the contract – the treaty – was intended to so provide. Later amendments of internal law do not amend the treaty – they amend its application.

It is to be regretted that this static/ambulatory issue has never been publicly addressed by the OECD in the wording of Article 3(2) or in the Commentary. Because of its importance, it is to be hoped that some clarification of the powers, and limits to the powers, to amend the application of the treaty will appear, either by a re-worded Article 3(2), or an expanded Commentary, or both. Many States have done this in their credit Articles by agreeing to provide a credit for taxes imposed by the other State, as provided in internal law, as it may from time to time be amended, but without departing from the general principle that credit shall be given for foreign taxes.

Which brings us to the phrase ". . . unless the context otherwise requires . . .". These words limiting the application of Article 3(2) are important. They were omitted from the initial version of the Income Tax Conventions Interpretation Act, but were added before it passed into law.

What is the "context"? Although the Vienna Convention on the Law of Treaties (Article 31(2)) defines "context" to include the text of the treaty, its preamble and annexes and agreements and instruments made by the parties in connection with the conclusion of the treaty, the word "context" has a wider meaning, at least in Canadian law, dealing with statutory interpretation. Context also includes external context, that is to say, it includes matters outside the wording of the document itself, such as the state of the law and other circumstances prevailing when the document became effective. If the caveat to the application of internal law definitions represented by these words has any meaning, it is suggested that they might provide some reasonable restrictions on the use of internal law amendments in applying treaty provisions. Perhaps courts will address the hypothetical question whether the parties could be presumed to agree that a future internal law amendment (of which they would have no knowledge) should be applied where the application of the treaty becomes unduly unbalanced by virtue of such amendments. Where such an imbalance arises, the courts may be prepared to put a limitation on Article 3(2) "by virtue of the context".

It is, therefore, suggested that, viewed this way, the Supreme Court decision in *Melford* may have been correctly decided, but for the wrong reasons. Although Article 3(2) could have been found to be ambulatory, the recharacterisation of a guarantee fee which is part of the business profits of a bank, as a payment of interest, is so radical and therefore so unforeseeable, that the court might have found that the context would require that the amendment should be adopted for purposes of the Treaty.

Sir Ian Sinclair:

The last question which I posed at the beginning was:

> what is the significance of the principle of comtemporaneity in the context of determining whether a static or ambulatory meaning should be given to the provisions of internal law?

I wish to concentrate, at least for the time being, on the basic question whether Article 3(2) of the OECD Model requires the meaning under internal law to be determined by reference to the law current at the date of the treaty or that in force from time to time. This is the problem of what we international lawyers call the "intertemporal law". It is not always easy of solution. The classic statement of the principles of intertemporal law will be found in the award of Judge Huber in the *Island of Palmas* arbitration when he stated that:

> . . . a judicial fact must be appreciated in the light of the law contemporary with it, and not of the law in force at the time when a dispute in regard to it arises or falls to be settled.

Later in the same case, Judge Huber elaborated on this dictum by stating:

> As regards the question which of different legal systems prevailing at successive periods is to be applied to a particular case (the so-called intertemporal law), a distinction must be made between the creation of rights and the existence of rights. The same principle which subjects the act creative of a right to the law in force at the time the right arises, demands that the existence of the right, in other words, its continued manifestation, shall follow the conditions required by the evolution of the law.

At this point, something must be said about the facts of the *Island of Palmas* case, in order to understand the significance of the dicta. A dispute arose between the United States and the Netherlands concerning title to the Island of Palermo. The United States based its title on a cession of the island by Spain in the Treaty of Paris in 1898. It was contended by the United States that Spain had acquired her title to the Island by means of discovery in the seventeenth century and that the United States was Spain's successor-in-title. In the seventeenth century, contemporary international law recognised their discovery as one of the roots of title to the territory; but by the beginning of the twentieth century, mere discovery without more had ceased to confer a valid titled to the territory – there had to be a clear manifestation of the exercise of sovereignty for the title to be valid. In these circumstances, the award of the arbitrator in favour of the Netherlands is understandable; while the United States had been able to prove the original title of Spain on the basis of discovery in the seventeenth century, she had not been able to demonstrate the continuing manifestation of this title in the face of subsequent acts of administration by the Netherlands and in relation to the Island.

Both links of the doctrine of intertemporal law as expounded by Judge Huber in the *Island of Palmas* case were applied by the International Court of Justice in another case relating to title to territory – namely, the *Minquiers and Ecrehos* case between France and the U.K. As Judge Elias points out in his book *The International Court of Justice and some Contemporary Problems:*

> The rule of intertemporal law in modern international law was accepted by both parties as applicable to the case. The Court therefore adopted the principle laid down in the Island of Palermo arbitration to the effect that the maintenance of the territorial title to it, was to be determined not only by the law contemporaneous with the creation or acquisition of the title, but also by the rules governing the matter as it evolved through the period during which the sovereign authority was purported to have been exercised by the party claiming the subsequent title.

From this doctrine of intertemporal law the late Sir Gerald Fitzmaurice formulated in 1957 in the context of an analysis of the rules of treaty interpretation what he regarded as the principle of contemporaneity, that is to say:

> The terms of a treaty must be interpreted according to the meaning which they possessed, or which would have been attributed to them, at the time when the treaty was originally concluded.

Now it should be said at once that the principle of contemporaneity, as formulated by Sir Gerald Fitzmaurice, does not necessarily provide a decisive reason for supporting a "static" rather than an "ambulatory" meaning of a term in internal law when Article 3(2) of the OECD Model requires that the meaning should be determined by internal law. Let me seek to explain why.

In the first place the examples given by Sir Gerald relate to the interpretation of *substantial* provisions in old treaties. In the case of *Rights of United States Nationals in Morocco*, the International Court of Justice was called upon to interpret the meaning of the term "dispute" in a treaty of 1836. Did it cover both civil and criminal disputes? The Court noted that the treaty of 1836 had replaced an earlier treaty of 1787 and that the two treaties were substantially identical in terms. The Court concluded, not unnaturally, that "it is necessary to take into account the meaning of the word *disputes* at the time when the two treaties were concluded". After referring to the way in which the word was used in the different treaties concluded by Morocco with other countries in the seventeenth and eighteenth centuries, and taking into account the circumstance that, at the times of the two treaties, the clear-cut distinction between civil and criminal matters had not yet been developed in Morocco, the Court construed the word *dispute* as covering both civil and criminal disputes.

It will be apparent that this interpretation can be explained away on the basis that it is simply a special application of the principle of the natural and ordinary meaning *in the context in which the term occurs,* because if one takes account of the context, it is evident that the meaning of the term *dispute* must be that attributed to it by the Court.

In the second place, the principle of contemporaneity is not absolute. It has to be understood and applied in the light of qualifications which have been put on it by subsequent international jurisprudence. Let me give two examples. In its advisory opinion on *Namibia* in 1971, the International Court of Justice, within carefully circumscribed limits, interpreted certain clauses contained in the Covenant of the League of Nations in an ambulatory rather than a static manner:

> Mindful as it is of the primary necessity of interpreting an instrument in accordance with the intentions of the parties at the time of its conclusion, the Court is bound to take into account the fact that the concepts embodied in Article 22 of the Covenant – "the strenuous conditions of the modern world" and "the well-being and development" of the peoples concerned – were not static, but were by definition evolutionary, as also, therefore, was the concept of "sacred trust". The parties to the Covenant must consequently be deemed to have accepted them as such. That is why, viewing the institutions of 1919, the Court must take into consideration the changes which have occurred in the supervening half-century, and its interpretation cannot remain unaffected by the subsequent development of law, through the Charter of the United Nations and by way of customary law. Moreover, an international instrument has to be interpreted and applied within the framework of the entire legal system prevailing at the time of the interpretation.

So it will be seen that, at least in the context of the interpretation of terms that can be argued to denote relative or evolving notions, the principle of contemporaneity has to be heavily qualified.

My second example is taken from the *Aegean Continental Shelf* case (between Greece and Turkey) decided by the International Court of Justice in 1978. One of the issues in this case, at the judicial stage, concerned the interpretation of a Greek reservation to the General Act on the Peaceful Settlement of International Disputes of 1928. The reservation excluded *inter alia* disputes ". . . resulting to the territorial status of Greece". The Greek Government argued that this part of the reservation could not be applicable to her continental shelf dispute with Turkey since the very idea of the continental shelf was unknown in 1920 when the General Act was concluded and in 1931 when Greece acceded to it. The Court found that the term "territorial status" in the Greek reservation was a generic term which in the practice of the time (the League of Nations) was understood as embracing the integrity and frontiers, as as well as the legal regime, of the territory in question. Turning more particularly to the Greek argument that the continental shelf doctrine was unknown in 1928 and 1931, the Court stated:

> Once it is established that the expression "the territorial status of Greece" was used in Greece's instrument of accession as a generic term denoting any matters comprised within the concept of territorial status under general generic law, the presumption necessarily arises that its meaning was intended to follow the evolution of the law said to correspond with the meaning attached to the expression by the law in force at a given time.

Here again, the Court was upholding an ambulatory, rather than a static, interpretation of a term contained in an instrument.

Finally, I would draw attention to one aspect of the background material to the Vienna Convention rules on interpretation themselves. As I have already indicated the Vienna Convention rules are based upon proposals made by the International Law Commission. Indeed, they were taken over virtually unchanged, from the final set of draft articles proposed by the Commission. The Commission had, in 1964, proposed, on first meeting, a general rule of interpretation formulated as follows:

> A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to each of them:
> (a) in the context of the treaty and in the light of its objects and purposes; and
> (b) in the light of the rules of general international law in force at the time of its conclusion.

There was, however, a division of opinion within the Commission on this formulation. Some members, while accepting that the initial meaning of the terms of a treaty should be found by reference to the law in force at the time of its conclusion, took the view that the interpretation of the treaty might be affected by subsequent changes in the general rules of international law. The majority, on the other hand, considered that the effect of changes in the law upon a treaty was more a question of the *modification* of the rule laid down in the treaty by a later legal rule than one of the interpretation of the terms of the treaty itself. In the event the Commission dropped the phrase "in force at the time of its conclusion" in their final draft of the general rules of interpretation which has now become Article 31 of the Convention.

They explained their shift of attitude as follows:

> On re-examining the provisions, the Commission considered that the formula used in the 1964 text was unsatisfactory, since it covered only partially the question of the so-called intertemporal law and its application to the interpretation of treaties and might, in consequence, lead to misunderstanding. It also considered that, in any event, the relevance of rules of international law for the interpretation of treaties in any given case was dependent on the intentions of the parties, and that to attempt to formulate a rule covering comprehensively the temporal element would present difficulties. It further considered that correct application of the temporal element would normally be indicated by interpretation of the term in good faith. The Commission therefore concluded that it should omit the temporal element and revise the reference to international law so as to make it read "any relevant rules of international law applicable to the relations between the parties".

Now, I should immediately say that these instances I have given, relate to the interpretation of the *substantive* terms of a treaty itself or of an instrument related to a treaty. They are not therefore directly relevant to the interpretation of a term under internal law when a treaty requires that references be made to the meaning under internal law. Nevertheless, I would suggest that, at least by analogy, they may provide some guidance on the question of whether a static or an ambulatory meaning should be given to a term under internal law when a treaty directs that the internal law should provide the meaning.

I think it is clear from what I have said that I do not regard the principle of contemporaneity formulated by Sir Gerald Fitzmaurice as requiring that a static interpretation be given to a term under internal law when Article 3(2) of the OECd Model requires that reference be made to internal law. In principle, therefore, and subject to what may emerge in the course of the discussion this afternoon, I am inclined to favour the ambulatory approach, the more particularly because this would appear to correspond with the intentions of the drafters of the OECD Model (if indeed any conclusion can be drawn as to their intentions!). But it must be an ambulatory approach subject to inherent limitations. Some of these limitations, I would suggest, flow from the fact that Article 3(2) itself is a treaty text. It is not to be assumed that the application of Article 3(2) would or could lead to a result which would defeat the object and purposes of the treaty itself. A major change in internal law could have this effect and should therefore not be taken into account. It may be that this case could be regarded as falling within the orbit of the phrase "unless the context otherwise requires" as has been suggested. But I would have thought that a major change in internal law which was either incompatible with the object and purpose of the treaty or involved an upsetting of the balance achieved by the treaty could in any event be ignored on the broader ground as indeed Article 27 of the Vienna Convention of the Law of Treaties provides, that a State is not entitled to invoke a provision of its internal law as justification for its failure to perform a treaty.

I have perhaps said enough to provide an introduction to the fascinating theme of this Seminar. But I would not wish to conclude without a personal reminiscence which is relevant to the doctrine of intertemporal law in the interpretation and application of treaties. Some 25 years ago, when I was still a relatively junior legal adviser in the Foreign Office, I was asked by an official in one of the departments which I was then advising, in the context of the Indian takeover of Goa, what the U.K. Government's reaction should be if Portugal were to invoke her dormant treaty of alliance with us, dating, you will recall, from the late 14th Century. I duly looked up the text of the treaty and discovered that the then King of England had given a commitment that, if the King of Portugal were attacked in his possessions, he (the King of England) would send "a goodly company of archers" to his aid. The advice I gave then was based in part on the doctrine of intertemporal law. Obviously at the time of the conclusion of the treaty of alliance in the 14th Century, the King of Portugal's possessions were confined to Europe and did not extend to any possessions in the Indian subcontinent. So the treaty of alliance did not apply in this particular case, at least in my view. I might say that I added jocularly, and very much with tongue in cheek, that if my view were mistaken, we might have to contemplate activating the Royal Company of Archers which would undoubtedly have been a considerable shock to the distinguished and elderly members of that body who operate as the Queen's Bodyguard in Scotland. In the event, and very much to everybody's relief, Portugal did *not* invoke the treaty of alliance so that the issue never came to a head. I simply mention this incident as a further illustration of some of the difficulties inherent in the temporal application of treaty provisions.

Professor Vogel also stated that in Germany it had never been doubted that Article 3(2) was to be given an ambulatory interpretation. The only contrary authority was a case concerning wealth tax under a treaty not containing Article 3(2), where a static interpretation had been given, but this result depended on the context.

Mr. van Raad also said that the courts in the Netherlands favoured the ambulatory approach.

A questioner from the floor asked whether the word "term" included a concept. David Ward, referring to dictionary definitions, considered that it did. For example alienation, disposal and disposition used in relation to capital gains tax were different terms for one concept. Kees van Raad agreed. Professor Vogel considered that a term was a word or phrase and a concept was different.

Conclusion

The Chairman pointed out the general acceptance of the ambulatory interpretation of Article 3(2). Sir Ian Sinclair's limitation by reference to the object and purpose of the treaty, possibly also relying on Article 27 of the Vienna Convention, seems the anwer to the extent of possible changes, but leaves matters in doubt in practice. Perhaps the OECD should consider some means of one State communicating acceptance for treaty purposes of a change in the other State's law which has been communicated to it.

BRITISH BRANCH

On 5 February 1986 a meeting of the British Branch of IFA will be held in the offices of Touche Ross & Co, Hill House, 1 Little Street, London E.C. Mr. Iain P.A. Stitt of Arthur Andersen & Co., Leeds (President of the Institute of Taxation 1982-84) will speak on: *Enacting the Keith Committee proposals – where next?* Although the Government has deferred action on the Keith proposals on direct taxation for a year, the subject is no less important and the Inland Revenue is anxious to promote as much discussion and representation as possible. Mr. Stitt will cover the present position, including the international aspects and developments during the last 18 months. (Note that the Keith report deals with the enforcement measures which may be taken by the tax authorities.)

SWISS BRANCH

The Swiss Branch of IFA has invited its members to attend a special meeting on 7 February 1986 in Basel. Mr. Raoul Lenz will give his thoughts on recent developments and Mr. Daniel Lüthi will speak on the current situation and anticipated trends. A panel discussion will be chaired by Mr. Max Beat Ludwig with the assistance of Messrs. Kurt Schüle, Daniel Lüthi, Arnold Roth, Raoul Lenz, Jean-Paul Chapuis and Theodor Faist. Apart from the IFA Congress (7-12 September 1986), the Swiss Branch will meet on 13 June 1986 in Zurich and on 6 November 1986 in Bern.

U.S.A. BRANCH

On 27 and 28 February 1986 the U.S.A. Branch of IFA will hold its Annual Meeting in the Marriott Marquis Hotel in New York. The following subjects will be discussed:
– *Recent legislative and policy developments on the international tax scene* – Roger Mentz (Acting) Assistant Secretary of the Treasury for Tax Policy;

– *Planning for foreign tax credits in 1986* – Robert Henry, Partner, Coopers & Lybrands, New York, N.Y., Paul Farber, Partner, Ernst & Whinney, New York, N.Y., Raymond Haas, Partner, Arthur Young & Co., New York, N.Y.;

– *Tax aspects of transfers of technology* – Robert Mattson, Director of Taxes, IBM, New York, N.Y. – Moderator, Pat Moran, Tax Director, Merck, Morristown, New Jersey, Joseph L. Andrews, Associate International Tax Counsel, U.S. Treasury Department;

– *Financing international operations in 1986* – Robert Mendoza, Executive Vice President, Morgan Guaranty Bank and Trust, New York, N.Y., Joseph Guttentag, Partner, Arnold & Porter, Washington, D.C., Willard Taylor, Partner, Sullivan & Cromwell, New York, N.Y.;

– *The role of government in international tax life* – Charles Kingson, Partner, Wilkie Farr & Gallagher, New York, N.Y., David Tillinghast, Partner, Hughes, Hubbard & Reed, New York, N.Y.;

– *Planning for inbound investments* –
(i) Separate branch level tax – Robert DeCelles, Partner, Peat, Marwick, Mitchell & Co., New York, N.Y., John Corry, Partner, Davis Polk & Wardwell, New York, N.Y.,
(ii) Life After Rev. Rul. 84-152;

– *Foreign investment in U.S. real estate* (Partnership considerations and other matters) – Fred Feingold, Partner, Roberts and Holland, New York, N.Y., Richard Loengard, Partner, Fried Frank Harris Shriver & Jacobson, New York, N.Y., Robert Hudson, Partner, Arky, Freed, Stearns, Watson, Greer & Weaver, P.A., Miami, Florida, Leo S. Ullman, Partner, Reid & Priest, New York, N.Y. – moderator;

– *Release of information by the U.S. and gathering of information by the U.S.* – Harvey Dale, Professor of Law, New York University School of Law; of counsel, Cadwalader, Wickersham & Taft, New York, N.Y., Michael Saltzman, Saltzman & Holloran.

Guest speakers at luncheons and dinners will be: Congressman Charles Rangel (D) Manhattan, Congressman Raymond McGrath (R) Nassau County, New York and William Diefendorfer, Chief Counsel, Senate Finance Committee.

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  II, release 232
- Algemene wetgeving
  releases 176, 177
- Belastingheffing bij invoer
  release 339

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releases 63, 64
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CUMULATIVE INDEX 1986 – No. 1

I. ARTICLES:

Contents

of the March 1986 issue

THE INTERNATIONAL BAR ASSOCIATION (BUSINESS SECTION)

The activities of Committee "N" (Taxes)

The Business Section of the International Bar Association held its 7th Conference in Singapore from 30 September to 4 October 1985. Committee "N" (Taxes) met on the occasion during three days. Proceedings were as follows:

First session: National developments of importance to international tax lawyers

The following persons submitted reports: Bruno Gangemi (Secretary) (Italy), Reinhard Poellath (Federal Republic of Germany), Hirotomi Kimura (Japan), Stanley Weiss (United States), Karel de Vries (The Netherlands), Anthony L. Angel (United Kingdom), Roy Randall (Australia).

These reports shall be published in the "Business Lawyer" edited by the Section.

Second session: Corporate migration, principles and planning

This session was the continuation of prior discussions held in Vienna (Austria) in 1984.

The attention was focused on four areas introduced each by a "key" speaker and illustrated by cases outlining the various issues raised by the subject: Tax implications of dual residence (Peter Lier, the Netherlands), Minimizing the impact of involuntary transfers of residence (Dr. Jürgen Killius, German), Planning for tax saving through voluntary migration (James P. Fuller, U.S.A.), Group planning for multiple level tax minimization (Victor Peters, Canada).

National report on corporate migration covering about 20 countries shall be published as an I.B.A. Publication in 1986.

Third session: tax regimes, incentives and treaties affecting foreign business investments and expatriates in territories of the Asian-Pacific Regime.

Committee "N" was particularly fortunate in having been able to plan this program oriented towards the region where the Conference was held. Indeed the Asian Pacific Tax and Investment Research Centre, headquartered in Singapore accepted to take responsibilities for the preparation of the meeting which was held as a joint Session under the Chairmanship of Prof. Jaap van Hoorn jr., Chairman of the Centre.

Each participant received extensive documentation on nine countries of the region.

Discussions centered around the following subjects, for which representatives from Germany (Dr. Poellath), Canada (James S. Hausman) and Australia (David K.L. Raphael) suggested questions from the perspective of the capital exporting countries.

Title	*Speaker*
Taxation and foreign investment: Principle and attitudes	O.P. Vaish (India)
The use of subsidiaries, branches, joint ventures: Sales and representation	Elizabeth Thompson (Hong Kong & Canada)
Expatriates: permits-taxes	Mrs. Sri Indrastuti Hadiputranto, S.H. (Indonesia)
Contractors fees and similar payments	N.J. Thakurdas (Malaysia)
Policy regarding tax incentives	Sidney C. Rolt (Singapore)
Tax sparing	James S. Hausman (Canada)
Policy regarding tax treaties – experience with UN model	Prof. Jaap van Hoorn

The next meeting will be held in New York (14 September to 19 September 1986) with the following agenda:

Day 1
Taxes and high tech operations.

Day 2
National tax developments which international tax lawyers need to know (list of countries will be communicated later).

Day 3
U.S. Government perspectives on current international tax issues (this meeting includes the participation of representatives from the the Treasury Department and other agencies of the U.S. Government. It will be opened to all members of the SBL participating in the Congress).

A parallel meeting will be held at the same time on:
Tax treatment of cost contribution arrangements.

The Committee publication on Tax Avoindance – Tax Evasion is currently being updated in view of a second edition to appear in 1986.

Multilateral Instruments on the Avoidance of Double Taxation

By H.M.A.L. Hamaekers*

This article discusses the feasibility and advantages (or disadvantages) of multilateral conventions on the avoidance of double taxation in comparison with bilateral conventions (Part I). Secondly, it deals specifically with a recent example of a multilateral convention, that is the Nordic Multilateral Double Taxation Convention on Income and Capital (Part II) (hereinafter, the Nordic Tax Convention). Conclusions are given in Part III.

Following this article is an unoffical English translation of the Convention.

I. FEASIBILITY AND ADVANTAGES OF MULTILATERAL TAX CONVENTIONS

Introduction

The OECD countries are connected through a dense network of bilateral double taxation conventions. More than 200 conventions are in force or signed among these countries out of a theoretical maximum of 276.

Together with the adoption of the OECD Draft Double Taxation Convention in 1963 (hereinafter OECD Draft) and the Model Convention in 1977 (hereinafter OECD Model), the OECD Council recommended to the member states to examine the feasibility of concluding multilateral conventions among themselves based upon the Draft and the Model respectively.

Given the facts of a 72% network density and the OECD recommendation, why are there no serious efforts being made to negotiate such a convention among the OECD countries?

There is the recent example of the Nordic Tax Convention between Denmark, Finland, Iceland, Norway and Sweden of 22 March 1983, but this convention should be looked upon as a logical follow-up to existing Nordic conventions and cooperation.

The question arises, are multilateral conventions on the avoidance of double taxation desirable and feasible?

Multilateral conventions may have the advantage of more uniformity in regulations and in interpretation and, consequently, of fewer application problems. Bilateral conventions still vary in many clauses, although the OECD Draft and Model with their extensive commentaries, have brought about conformity on major points. Another advantage of multilateral conventions, at least from the tax authorities' point of view, is that increased uniformity may reduce the possibility of treaty shopping.

Apart from the Nordic Tax Convention, examples of multilateral conventions are: the OCAM Treaty of 1971[1], the Andean Tax Treaty of 1971[2], and the Arab Tax Treaty of 1973[3]. Only the Andean Treaty is effective (as from 1 January 1981).

Among the CMEA (Comecon) countries, two multilateral tax conventions have been in force since 1979[4]. A single income class multilateral convention is the Unesco-WIPO Convention on the Avoidance of Double Taxation of Copyright Royalties of 1979.[5]

Preparation and revision of multilateral tax conventions

The preparation and negotiation of a multilateral convention is extremely difficult and laborious.

Preparatory meetings of tax experts are needed, generally followed by a so-called diplomatic conference where the ultimate negotiations take place.

A complicating factor is that in such conferences – in contrast to bilateral negotiations on tax matters – the

* Chief executive of the International Bureau of Fiscal Documentation, Amsterdam. The author is indebted to Mr. B.P. Dik, deputy director of the International Bureau of Fiscal Documentation, for his comments on Part II of this article and his translation of the Nordic Tax Convention, which follows this article.

1. General Convention of Fiscal Cooperation between the Member States of O.C.A.M. (l'Organisation Commune Africaine, Malgache et Mauricienne), Fort Lamy, 29 January 1971 (included in *African Tax Systems*, part E, published by the International Bureau of Fiscal Documentation).
2. Andean Group Convention for the Avoidance of Double Taxation, Cartagena, 16 November 1971 (included in *Corporate Taxation in Latin America*, part D, published by the International Bureau of Fiscal Documentation).
3. Agreement for the Avoidance of Double Taxation and Prevention of Tax Evasion between the States of the Arab Economic Union Council, Cairo, 3 December 1973 (included in *Taxes and Investment in the Middle East*, published by the International Bureau of Fiscal Documentation).
4. Treaty for the Avoidance of Double Taxation of Individuals, Miskolc, 27 May 1977. Treaty for the Avoidance of Double Taxation of Legal Entities, Ulan Bator, 19 May 1978 (both treaties included in *Taxation in European Socialist Countries*, published by the International Bureau of Fiscal Documentation).
5. Unesco-Wipo Convention on the Avoidance of Double Taxation of Copyright Royalties of 1979, Madrid (The text of this treaty is not published by the International Bureau of Fiscal Documentation as the treaty did not reach a sufficient number of signatories to enter into force. The text is available from the International Bureau of Fiscal Documentation).

Ministries of Foreign Affairs of many countries often take over the responsibility and send their own negotiators. With all due respect for the abilities of diplomats, international tax matters, however, are of such a special nature that only experts can properly deal with them. Moreover, diplomats may take general political considerations more seriously than fiscal principles and practical exigencies.

A major disadvantage of multilateral conventions is their rigidity. If, for instance, changes in economic circumstances, in tax laws or in the fiscal policy of a country make the revision of a bilateral convention necessary, delegations of the two countries concerned can meet in an informal way and on a short-term basis. Often, they reach an agreement in one session.

For the revision of a multilateral convention, however, the same heavy and lengthy procedure is needed as for the conclusion of the convention. Flexibility is also hampered by the circumstance that a certain number of countries (generally, one third of the countries that have ratified the convention) is necessary to support the revision proposal before a conference can be organized.

Another disadvantage of multilateral conventions is that specific wishes of countries may only be met to a certain limited extent. A proper multilateral convention can rarely ever represent more than the greatest common denominator of the specific wishes of the countries involved. In practice, the problem may be solved by reservations or special clauses, but this reduces the advantages of uniformity that these conventions, in principle, have.

Multilateral conventions with limited scope

Would a multilateral convention covering one single item or a few items be more feasible than a comprehensive multilateral convention?

In 1978, the Economic and Social Commission on Asia and the Pacific (ESCAP) recommended the conclusion of multilateral conventions in fiscal matters. The U.N. Commission determined that the immediate endeavors should not be to cover all existing problems, but should be limited in scope to those subjects on which general agreement could be easily reached.[6]

An example of a multilateral tax convention covering one single class of income is the Unesco-WIPO Convention on the Avoidance of Double Taxation of Copyright Royalties. The result of five years of preparatory work, six weeks of expert meetings, and – in 1979 – a three-week diplomatic conference is a useless convention signed only by three of the 44 countries taking part in the conference. The convention contains various definitions, "guiding principles", and general provions, but not one material rule for the avoidance of double taxation, although the conference was set up for that purpose. The most pertinent provision (Article 8, para. 1) reads:

> (e)ach contracting State undertakes to make every possible effort, in accordance with its constitution and the guiding principles set out above, to avoid double taxation of copyright royalties, where possible, and, should it subsist, to eliminate it or to reduce its effect. This action shall be carried out by means of bilateral agreements or by way of domestic measures.

Even if a theoretical consensus existed concerning the attribution of the right to tax a particular class of income internationally, in practice the specific budgetary interests of the countries involved and the specific situation of their taxpayers, with regard to the item of income concerned, will strongly influence the positions taken.

Furthermore, negotiations on a single item or on a few items either do not, or only marginally, give the opportunity to reach compromises, as compared to comprehensive conventions, and, in particular, to bilateral comprehensive conventions.

Comprehensive multilateral tax conventions

The feasibility of a multilateral tax convention largely depends on a number of national circumstances and aspects of the countries involved.

A major point is the level of economic development. The tax systems and the attitudes of countries towards taxation are strongly influenced by their economic infra-structure. If the differences between countries are great on this point, it is hardly possible to conclude a multilateral convention. Apart from a high degree of similarity in legal systems and, in particular, tax laws, a less tangible aspect, the relation between tax authorities and taxpayers, may be important. Where does the emphasis lie: on the budgetary aspect or on the protection of taxpayers against "big brother"? The attitude in this respect may influence clauses in a tax convention, for instance, the clauses on exchange of information (safeguards for taxpayers against possible negative side-effects of exchange of information between tax authorities) and on associated enterprises (the recognition of economic double taxation as a serious problem for companies (big and small) operating in more than one country).

Another circumstance which may influence the positions taken in treaty negotiations is the presence of multinational enterprises. Either parent companies or subsidiaries may predominate in a country. According to the factual situation this may have an impact on the drafting of the article on associated enterprises and on the right to tax at source intercompany dividends, interest, and royalties.

The position taken by countries concerning the provisions on dividends, interest, and royalties is, of course, also influenced by the question whether a country on balance is a "paying" or "receiving" country.

In bilateral relations, differences between parties, as

6. U.N. Economic and Social Commission on Asia and the Pacific. Report of the Third Seminar on Foreign Investment and Tax Administration, Tokyo, December 1978.

mentioned, can in many cases be bridged by concessions on both sides. In a multinational context, the pattern of specific wishes is generally much more complicated, and concessions on one side cannot easily be followed by matching concessions on the other, as these may create problems for other countries taking part in the negotiations.

EEC instruments

What about an EEC instrument for the avoidance of double taxation among the EEC countries?

Article 100 of the EEC-treaty serves as a basis (a disputed basis, however) for directives and proposed directives in the field of direct taxation. It might be used by the European Commission as a basis for a proposal for a comprehensive directive on the avoidance of double taxation.

In 1976, the Commission transmitted to the Council a proposal for a directive on the elimination, through an arbitration procedure, of double taxation arising from adjustments of transfer prices. The member states, however, decided to prepare a draft multilateral convention based on Article 220 of the Treaty that would resolve the problems dealt with in the proposed directive. Article 220 refers to negotiations among the member states on the abolition of double taxation within the Community.

Why have this and other proposed directives in the field of direct taxation had so little success? The only direct taxation directive adopted is the 1977 Directive on Mutual Assistance.[7]

An explanation may be that the member states fear an extension of the external competence of the EEC.

Since the AETR case in 1970 and the Kramer case in 1976[8], it is EEC case law that the EEC is exclusively competent for relations with non-EEC countries – even in cases where no explicit competence is given in the EEC Treaty – insofar as this is necessary for the exercise of the internal powers of the EEC.

For instance, given the fact of a system of mutual assistance within the EEC, the Commission may claim exclusive competence for negotiating arrangements of this kind with third countries. An EEC directive on the avoidance of double taxation would entail exclusive competence for the EEC to conclude bilateral EEC-third country tax conventions. Apparently, member states are reluctant to give up their competence in this respect.

The only conceivable multilateral instrument for the avoidance of double taxation within the EEC would therefore be a treaty among the EEC-countries based on Article 220. A first attempt to conclude such a treaty was made in the early sixties. The "Six" then, however, concluded that it first was necessary to harmonize direct taxes in member countries. Presently, no visible efforts are being made in the EEC to prepare a multilateral treaty on the avoidance of double taxation.

II. THE NORDIC TAX CONVENTION

Introduction

The Nordic Tax Convention is the only example of a comprehensive multilateral double taxation convention among OECD countries.

It was concluded among the members of the Nordic Council – Denmark, Finland, Iceland, Norway and Sweden – and replaces ten bilateral comprehensive tax conventions.

Preparatory work was done within the European Free Trade Association, but after five years the EFTA working party reported that they could not, for the time being, recommend the conclusion of a multilateral convention.

However, within the Nordic countries the prerequisites for a multilateral tax convention were more favorable than within EFTA. Their legal systems and tax laws have basic features in common, and, among these countries, other successful multilateral cooperation has been achieved, such as the Nordic Convention on Mutual Assistance in Tax Matters of 1972.[9]

Even with such a favorable setting, it took many years of preparation and negotiations – starting in 1972 – before the convention was signed in 1983.

It is clear that the basis of the Convention is the OECD Model, with some of the provisions being adapted to the multilateral context. Some other provisions, however, deviate from or are not included in the OECD Model.

One of the advantages of the Convention is that all ten bilateral fiscal relationships have been updated at the same time. But, on the other hand, it may be more difficult in the future to adapt the Convention to special requirements of member countries than in bilateral relations. This problem is only partly solved by the inclusion in the protocol of alternative clauses (see point XI of the Protocol). Another expected advantage is greater uniformity in interpretation and application than under the ten bilateral conventions. The application of Article 28, para. 3 may indeed be conducive to this. It provides that bilateral mutual agreements between competent authorities cannot be concluded without informing the other contracting states. The competent authorities of these other states may

7. Council Directive of 19 December 1977 (77/799 EEC and 79/1070 EEC).
8. AETR Case 22-70, Court of Justice of the European Communities, Reports of Cases before the Court, 1971 at 263.
Cornelis Kramer and others, joined cases 3, 4 and 6/76, Court of Justice of the European Communities, Reports of Cases before the Court, 1976 at 1279.
9. Convention between the Kingdom of Sweden, the Kingdom of Denmark, the Republic of Finland, the Republic of Iceland and the Kingdom of Norway, regarding Mutual Assistance in Matters relating to Tax, Stockholm, 9 November 1972. In force on 1 January 1973 (included in *Supplementary Service to European Taxation*, Section C, published by the International Bureau of Fiscal Documentation).

then insist on consultations on the proposed bilateral decision.

The Convention consists of 32 articles and a protocol.

Contents of the convention

Assuming that the provisions of the OECD Model are widely known, only those aspects of the Convention which represent interesting and important deviations from or supplements to the OECD Model, are dealt with hereinafter.

Article 3 provides that the terms Denmark, Finland, Iceland, Norway and Sweden include the continental shelves of these countries. In connection with that article, Article 21 gives rules for taxation on the continental shelf.

Article 6, on income from immovable property, includes a special provision on income from shares of a company which has as a main objective the owning of immovable property. If the holder of the shares is entitled to use immovable property of the company, the income derived from the direct use, letting or other use may be taxed in the state where the property is situated.

In connection with that provision, Article 13 on capital gains provides that gains from the disposal of shares in such companies may be taxed in the state where the immovable property is situated. According to Article 23 on capital, the state where the immovable property is situated may tax the shares.

Article 8 on international shipping and air transport contains an additional clause in paragraph 1 to the effect that the state where the enterprise is incorporated takes over the right to tax the relevant income if and to the extent that the state where the place of effective management is situated has no power to tax under its national law.

Article 9 on associated enterprises contains a regulation in paragraph 2 which provides a consultation procedure in case of transfer pricing adjustments. The OECD Model, however, provides that if state B recognizes an adjustment made by state A, state B is obliged to make a corresponding adjustment.

Article 10 on dividends contains provisions similar to the provisions of Article 10 of the OECD Model, but it also includes clauses in paragraphs 4, 5, 8, 9 and 11 which deviate from the OECD Model rules. Icelandic and Norwegian tax on intercompany dividends may be raised from 5% to 15% if and to the extent that these dividends were deducted from the income of the paying company under the national income tax provisions (paragraphs 4 and 5). Paragraph 8 gives, under various conditions, participation exemptions with respect to dividends paid by a company resident of one contracting state to a company resident of another contracting state. This is an example of differences in national legislation requiring an extensive set of regulations which disturb the multilateral pattern. Paragraph 9 provides for reciprocal exemptions for charitable institutions. Paragraph 11 contains national definitions of partnership.

Interest is – according to Article 11 – only taxable in the state of residence of the recipient unless derived through a permanent establishment in the state of source. The term "beneficial owner" is not used.

Article 12 on royalties is similar to Article 11 on interest.

Article 13, capital gains, includes, apart from the aforementioned relation with Article 6, paragraph 4, specific clauses on the taxation of gains from the disposal of shares in Norwegian companies by former residents of Norway and of shares in Swedish immovable property companies by former residents of Sweden.

Article 15 on employment income deviates from the Model only in so far as income from employment aboard Nordic ships and aircraft is concerned. The place of effective management of the relative enterprise is not decisive, as it is in the OECD Model, but rather, the nationality of the ship or, with respect to aircraft and fishing boats, the residence of the employee is decisive.

Article 17 on artistes and athletes contains an additional clause to the effect that if the state where the activities are exercised cannot tax the income from the activities, then that income is only taxable in the state of residence.

According to Article 18, pensions, annuities, and social security payments are taxable only in the state of source. To the extent that Norway is unable, under its law, to tax such income the state of residence is entitled to do so (Protocol, point IX).

Article 19 on government service only covers the first paragraph of Article 19 of the OECD Model, supplemented by the provision that, if the paying state cannot tax the remuneration, the state of residence, if the services are rendered there, shall have the right to tax. Government pensions are covered by the main rule of Article 18. To the extent Norway is unable under its law to tax the above income, such income shall be taxable only in the state of residence of the recipient (Protocol, point IX).

Article 20 on students and apprentices includes two additional paragraphs.

Paragraph 2 provides that if students or apprentices work in another contracting state for not more than 100 days in one calendar year in order to obtain practical experience, the other state will only tax the part of the relevant income that exceeds 2000 Swedish kroner (or the equivalent in another Nordic currency) per month. The total exemption, however, may not exceed 6000 kroner.

In paragraph 3, the competent authorities are mandated to make arrangements on the application of paragraph 2 and to adjust the aforementioned amounts.

Article 21 gives detailed rules for taxation on the continental shelves of the contracting states. A provision of this kind is not included in the OECD Model.

The main rule provides that a resident of a contracting state who is carrying on business activities connected with the exploration or exploitation of natural resources on the continental shelf of another contracting state shall be deemed to have a permanent establishment there.

This rule is applicable if the activity is carried on for at least 30 days during a twelve-month period.

If the activities of associated enterprises performed on the continental shelf are to a large extent the same, then these activities are deemed to be performed by one enterprise when applying the 30-day rule.[10]

However, the provision of article 8, paragraph 1 is applicable to transport and supply activities, by ship or aircraft, on the continental shelf.

The articles on capital gains and on capital (Article 13, paragraph 4, and Article 23, paragraph 3) are applicable to gains from the disposal of these ships and aircraft and on the capital represented by these ships and aircraft.

Employment income earned by a resident of a contracting state in connection with the exploration or exploitation of natural resources off the coast of another contracting state is taxable in that other state if the employment is exercised for more than 30 days in a twelve-month period.

Article 23, concerning capital, contains a provision on shares in immovable property companies (see Article 6, paragraph 4) according to which the state where the immovable property is located may tax the shares.

If, with respect to ships and aircraft in international traffic, the state where the place of effective management of the enterprise is located cannot tax, the state of residence is entitled to tax.

The Convention also contains a provision on estates – Article 24 – which provides that if the state of residence of the deceased taxes income from and capital of the estate, then the other states where the beneficiaries reside cannot tax that income or capital.

According to Article 25 on methods for eliminating double taxation, Denmark, Finland and Sweden apply the ordinary credit method with a progression clause, whereas Iceland and Norway apply the exemption with progression method. The article contains specific provisions for each contracting state, supplemented in the Protocol by alternative regulations for Iceland and Norway which may replace the original regulation at their request.

Article 26 is specific for the multilateral character of the convention.

The article provides that income or capital of a resident of a contracting state may not be taxed in another contracting state unless taxation is explicitly allowed under the convention. This provision is included in order to prevent third contracting states from taxing in cases where the exclusive right to tax is not given to any state.

Article 27 (non-discrimination), in paragraph 5, explicitly allows preferential treatment of Norwegian nationals and citizens under a specific Norwegian tax law.

Article 28 on the mutual agreement procedure provides, in addition to the clauses of the OECD Model, that the result of consultations between competent authorities of two or more contracting states shall be communicated to the competent authorities of the other states before a decision is made. Upon request of any competent authority, the competent authorities of all states shall consult each other without delay on the relevant case.

Mutual assistance in tax matters is covered by the Nordic convention of 1972, so the 1983 Convention did not need to include a provision on exchange of information. This convention also provides for assistance in the allocation of taxes of the other contracting states.

The Convention entered into force on 29 December 1983 and is effective as of 1 January 1984 with respect to income tax, and 1 January 1985 with respect to capital tax.

III. CONCLUSIONS

Multilateral conventions on the avoidance of double taxation covering one item or a few items of income are hardly feasible due to the absence – largely – of "compromise-material".

Comprehensive multilateral tax conventions are feasible if basic conditions are met.

However, the multilateral character will, in practice, be diluted by specific clauses for the individual contracting states due to differences in national legislation.

An EEC Directive on the avoidance of double taxation is, at present, not conceivable, as member states are reluctant to give up competence to conclude tax conventions with non-member states.

From a theoretical point of view, comprehensive multilateral tax conventions have advantages over bilateral conventions. Multilateral conventions, however, cannot be revised easily. Moreover, the possible advantage of greater uniformity may be diminished by the requirement of specific clauses for each contracting state (see in particular Articles 10 and 25 of the Nordic Tax Convention).

Greater uniformity reduces the possibility of treaty shopping. Treaty shopping, however, can flourish primarily due to treaty provisions that are not suffi-

10. See footnote 2 of the English translation of this convention.

ciently backed by levying rights in the national legislation. The solution for this problem (included in the Nordic tax convention) – the right to levy the tax reverts to the state of residence if the state of source cannot exercise its taxing rights under the convention due to insufficient national legislation – is not a unique multilateral solution, as it can be applied in bilateral situations as well.

An ongoing process of refining the OECD Model Convention and of adapting it to new developments, together with moulding new and existing bilateral conventions to that model, would be more fruitful and practical than starting lengthy discussions which may result in rigid multilateral conventions that combine OECD-Model provisions and specific provisions for each party, like the U.S.-Model.

NORDIC (INCOME) TAX TREATY OF 22 MARCH 1983*

CONVENTION BETWEEN DENMARK, FINLAND, ICELAND, NORWAY AND SWEDEN FOR THE AVOIDANCE OF DOUBLE TAXATION WITH RESPECT TO TAXES ON INCOME AND ON CAPITAL

The Governments of Denmark, Finland, Iceland, Norway and Sweden,

Desiring to conclude a Convention for the avoidance of double taxation with respect to taxes on income and on capital,

Have agreed as follows:

Article 1
Personal scope

This Convention shall apply to persons who are residents of one or more of the Contracting States.

Article 2
Taxes covered

1. This Convention shall apply to taxes on income and on capital imposed on behalf of a Contracting State or of its political subdivisions or local authorities, irrespective of the manner in which they are levied.

2. There shall be regarded as taxes on income and on capital all taxes imposed on total income, on total capital, or on elements of income or of capital, including taxes on gains from the alienation of movable or immovable property, as well as taxes on capital appreciation.

3. The existing taxes to which the Convention shall apply are:

a) in Denmark:
   1) the income tax to the State (indkomstskatten til staten);
   2) the old age pension contribution (folkepensionsbidraget);
   3) the special old age contribution (det særlige folkepensionsbidrag);
   4) the contribution to the sickness "per diem" fund (bidraget til dagpengefonden);
   5) the sailors' tax (sømandsskatten);
   6) the special income tax (den særlige indkomstskat);
   7) the tax on dividends (udbytteskatten);
   8) the municipal income tax (den kommunale indkomstskat);
   9) the church tax (kirkeskatten);
   10) the income tax to the county municipalities (den amtskommunale indkomstskat); and
   11) the capital tax to the State (formueskatten til staten)

   (hereinafter referred to as "Danish tax");

b) in Finland:
   1) the national income and capital tax (valtion tulo- ja varallisuusvero);
   2) the municipal tax (kunnallisvero);
   3) the church tax (kirkollisvero);
   4) the sailors' tax (merimiesvero); and
   5) the withholding tax (lähdevero)

   (hereinafter referred to as "Finnish tax");

c) in Iceland:
   1) the national income tax (tekjuskattur til ríkisins);
   2) the municipal income tax (tekjuútsvar til sveitarfélaga); and
   3) the national capital tax (eignarskattur til ríkisins)

   (hereinafter referred to as "Icelandic tax");

d) in Norway:
   1) the income tax and capital tax to the State (inntekts- og formuesskatten til staten);
   2) the income tax and capital tax to the municipalities (inntekts- og formuesskatten til kommunene);
   3) the inome tax to the counties (inntektsskatten til fylkene);
   4) the tax to the equalization fund (fellesskatten til skattefordelingsfondet);
   5) the tax to the State on remuneration of foreign artistes (avgiften til staten på honorarer til utenlandske kunstnere m.v.); and
   6) the sailors' tax (sjømansskatten)

   (hereinafter referred to as "Norwegian tax");

e) in Sweden:
   1) the income tax to the State, including the sailors' tax and the coupon tax (den statliga inkomstskatten, däri inbegripna sjömansskatten och kupongskatten);
   2) the tax on public entertainers (bevillningsavgiften för vissa offentliga föreställningar);
   3) the tax on undistributed profits of companies (ersättningsskatten);
   4) the tax on companies distributing capital (utskiftningsskatten);
   5) the municipal income tax (den kommunala inkomstskatten); and
   6) the capital tax to the State (den statliga förmögenhetsskatten)

   (hereinafter referred to as "Swedish tax").

4. The Convention shall apply also to any identical or substantially similar taxes which are imposed after the date of signature of the Convention in addition to, or in place of, the existing taxes. The competent authorities of the Contracting States shall notify each other of any significant changes which have been made in their respective taxation laws.

5. The Convention shall not apply, as regards any of the Contracting States, to special taxes on lottery prizes and gambling winnings or to taxes on inheritances and gifts.

* Translated by Mr. B.P. Dik, Deputy Director of the International Bureau of Fiscal Documentation. It is understood that the Convention as translated by the Bureau may be subject to some amendments in the not too distant future. One of the amendments will be to remedy the drafting error in paragraph 2 of Article 21 (see our footnote). As soon as the amendments are published they will be translated and inserted in our Bulletin.

Article 3
General definitions

1. For the purposes of this Convention, unless the context otherwise requires, the terms below shall be defined as follows:

a) "Denmark" means the Kingdom of Denmark; "Finland" means the Republic of Finland; "Iceland" means the Republic of Iceland; "Norway" means the Kingdom of Norway; "Sweden" means the Kingdom of Sweden;
   – the term also comprises any area outside the territorial sea of a State within which that State under its legislation and in accordance with international law has rights with respect to the exploration and the exploitation of the natural resources of the seabed and subsoil (such area is referred to in this Convention as the "Continental Shelf");
   – the term "Denmark" does not comprise the Faroe Islands and Greenland; the term "Finland" does not comprise, with respect to the Finnish municipal tax, the county of Åland;[1] the term "Norway" does not comprise Spitsbergen (including Bear Island), Jan Mayen and the Norwegian dependencies ("biland") outside Europe;
b) "person" includes an individual, a company and any other body of persons;
c) "company" means any body corporate or any entity which is treated as a body corporate for tax purposes;
d) "enterprise of a Contracting State" and "enterprise of another Contracting State" mean respectively an enterprise carried on by a resident of a Contracting State and an enterprise carried on by a resident of another Contracting State;
e) "national" means an individual possessing the nationality of a Contracting State and a body corporate or other entity deriving its status as such from the law in force in a Contracting State;
f) "international traffic" means, for the application of this Convention in a Contracting State, any transport by a ship or aircraft operated by an enterprise which has its place of effective management in another Contracting State, except when the ship or aircraft is operated solely between places in the first-mentioned State;
g) "competent authority" means:
   1) in the case of Denmark: the Minister for Inland Revenue, Customs and Excise;
   2) in the case of Finland: the Ministry of Finance;
   3) in the case of Iceland: the Minister of Finance;
   4) in the case of Norway: the Ministry of Finance and Customs;
   5) in the case of Sweden: the Minister of Finance;

   or the authority in any of these States to whom the task of dealing with questions concerning this Convention has been delegated.

2. As regards the application of the Convention by a Contracting State any term not defined therein shall, unless the context otherwise requires, have the meaning which it has under the law of that State concerning the taxes to which the Convention applies.

Article 4
Fiscal domicile

1. For the purposes of this Convention, the term "resident of a Contracting State" means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature. But this term does not include any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein.

2. Where by reason of the provisions of paragraph 1 an individual is a resident of more than one Contracting State, then his status shall be determined as follows:

a) he shall be deemed to be a resident of the State in which he has a permanent home available to him; if he has a permanent home available to him in more than one State, he shall be deemed to be a resident of the State with which his personal and economic relations are closest (centre of vital interests);
b) if the State in which he has his centre of vital interests cannot be determined, or if he has not a permanent home available to him in any of the States, he shall be deemed to be a resident of the State in which he has an habitual abode;
c) if he has an habitual abode in more than one State or in none of them, he shall be deemed to be a resident of the State of which he is a national;
d) if he is a national of more than one State or of none of them, the competent authorities of the Contracting States concerned shall settle the question by mutual agreement.

3. Where by reason of the provisions of paragraph 1 a person other than an individual is a resident of more than one Contracting State, then it shall be deemed to be a resident of the State in which its place of effective management is situated.

Article 5
Permanent establishment

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

2. The term "permanent establishment" includes especially:

a) a place of management;
b) a branch;
c) an office;
d) a factory;
e) a workshop; and
f) a mine, an oil or gas well, a quarry or any other place of extraction of natural resources.

3. A building site or construction or installation project constitutes a permanent establishment only if it lasts more than twelve months.

4. Notwithstanding the preceding provisions of this Article, the term "permanent establishment" shall be deemed not to include:

a) the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise;
b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;
c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;
d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise;
e) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character;
f) the maintenance of a fixed place of business solely for any combination of activities mentioned in sub-paragraphs a) to e), provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.

5. Notwithstanding the provisions of paragraphs 1 and 2, where a person – other than an agent of an independent status to whom paragraph 6 applies – is acting on behalf of an enterprise and has, and habitually exercises, in a Contracting State an authority to conclude contracts in the name of the enterprise, that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph.

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

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

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1. The exclusion, for purposes of the Finnish municipal tax, of Åland in Art. 3, paragraph 1a) was abolished by an exchange of notes of 24 May 1984, effective from 1 January 1984.

Article 6
Income from immovable property

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

2. a) Subject to the provisions of subparagraph b), the term "immovable property" shall have the meaning which it has under the law of the Contracting State in which the property in question is situated.
b) The term shall in any case include property accessory to immovable property, livestock and equipment used in agriculture and forestry, rights to which the provisions of general law respecting landed property apply, usufruct of immovable property and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources.

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

4. Insofar as the ownership of shares or other corporate rights in a company, the most essential object of which is to own immovable property, entitles the owner of such shares or corporate rights to the enjoyment of immovable property owned by the company, the income derived from the direct use, letting, or use in any other form of such entitlement to enjoyment may be taxed in the Contracting State in which the immovable property is situated.

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

6. The provisions of paragraph 4 shall also apply to the income from an entitlement to enjoyment which belongs to an enterprise or is used for the performance of independent personal services.

Article 7
Business profits

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

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

3. In determining the profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes of the permanent establishment, including executive and general administrative expenses so incurred, whether in the State in which the permanent establishment is situated or elsewhere.

4. Insofar as it has been customary in a Contracting State to determine the profits to be attributed to a permanent establishment on the basis of an apportionment of the total profits of the enterprise to its various parts, nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary; the method of apportionment adopted shall, however, be such that the result shall be in accordance with the principles contained in this Article.

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

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

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

Article 8
Shipping and air transport

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. To the extent that such State is unable, under its law, to tax the entire profits, the profits shall be taxable only in the State of which the enterprise is a resident.

2. If the place of effective management of a shipping enterprise is aboard a ship, then it shall be deemed to be situated in the Contracting State of which the operator of the ship is a resident.

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

Article 9
Associated enterprises

1. Where
(a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of another 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 another Contracting State,

the following shall apply.

If 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.

2. If in a Contracting State an issue as referred to in paragraph 1 arises, the competent authority of another Contracting State which is involved in the issue shall be informed with a view to considering an adjustment to the computation of the profits of the enterprise which is a resident of that other State. The competent authorities may, if necessary, conclude a reasonable agreement as regards the apportionment of profits.

Article 10
Dividends

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

2. If a recipient of dividends who is a resident of a Contracting State has a permanent establishment or a fixed base in a Contracting State other than the State of which he is a resident, and the holding by virtue of which the dividends are paid is effectively connected with a business carried on from that permanent establishment, or with independent personal services performed from that fixed base, as the case may be, dividends paid by a company which is a resident of a Contracting State to such a recipient may, notwithstanding the provisions of paragraphs 1 and 3, be taxed in accordance with the provisions of Article 7 or Article 14, as the case may be, in the Contracting State where the permanent establishment or fixed base is situated.

3. Dividends from a company which is a resident of a Contracting State to a resident of another Contracting State may also be taxed in the Contracting State of which the company paying the dividends is a resident and according to the laws of that State, but the tax so charged shall not exceed:
a) 5% of the gross amount of the dividends if the recipient is a company (excluding partnerships and estates of deceased persons) which owns directly at least 25% of the capital of the company paying the dividends;
b) 15% of the gross amount of the dividends in all other cases.

4. Notwithstanding the provisions of paragraph 3a), Icelandic tax on dividends may be increased from 5% to a maximum of 15%, to the extent that such dividends have been deducted in computing the profits of the company paying the dividends for the purpose of determining the Icelandic tax due.

5. Notwithstanding the provisions of paragraph 3a), Norwegian tax on dividends may be increased to a maximum of 15%. This provision applies as long as Norwegian companies are entitled to a deduction for distributed dividends for the purpose of computing the tax due to the State.

6. The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of the limitations under paragraphs 3 to 5.

The provisions of paragraphs 3 to 5 shall not affect the taxation of the company in respect of the profits out of which the dividends are paid.

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

8. Notwithstanding the provisions of paragraph 1, dividends from a company which is a resident of a Contracting State to a company which is a resident of another Contracting State, other than Denmark, shall be exempt from tax in that other State, to the extent that they would have been exempt if both companies had been resident there.

Notwithstanding the provisions of paragraph 1, dividends from a company which is a resident of a Contracting State other than Denmark to a company which is a resident of Denmark shall be exempt from tax in Denmark in accordance with Danish law.

However, to the extent that the amount of dividends distributed with respect to a year of income by a company which is a resident of Denmark, to a company which is a resident of another Contracting State, corresponds to dividends which the first-mentioned company, directly or through the intermediary of a legal person, in the same or a preceding tax year has derived from shares or other corporate rights in a company which is a resident of a third state, the exemption from tax in another Contracting State under the first sub-paragraph shall apply only if:

a) the dividends which have been derived from shares or other corporate rights in a company which is a resident of a third state have been subjected to tax in Denmark, or
b) if this is not the case, if the dividends would have been exempt from tax in another Contracting State, if the shares or other corporate rights in the company which is a resident of a third state had been owned directly by the company resident in the other Contracting State.

With respect to dividends from a company which is a resident of Iceland to a company which is a resident of another Contracting State, the exemption from taxation in another Contracting State under the first sub-paragraph shall apply only to the extent that the dividends are not deductible from the profits of the Icelandic company in computing Icelandic tax.

9. Notwithstanding the provisions of paragraphs 3 to 5, the competent authorities of the Contracting States may agree that dividends which accrue to an institution identified by name in the agreement, which has charitable or other general benevolent purposes and which, according to the laws of the Contracting State of which the institution is a resident, is exempt from tax with respect to dividends, shall be exempt from taxes imposed in another Contracting State on dividends from companies in that other State.

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

11. In this Article, the term "partnership" means:
a) with respect to Denmark: "interessentskab", "kommanditselskab" and "partrederi";
b) with respect to Finland: "avointa yhtiötä", "kommandiittiyhtiötä", "laivanisännistöryhtiötä" and any other body coming under paragraph 2 of Article 4 of the Income and Capital Tax Act (1043/74) and not taxed as a separate taxable person;
c) with respect to Iceland: "sameignarfélög" and "samlög", which are not taxed as a separate taxable person;
d) with respect to Norway: any body of persons, with the exception of "aksjeselskap" and "kommandittaksjeselskap";
e) with respect to Sweden: "handelsbolag", "kommanditbolag" and "enkelt bolag".

Article 11
Interest

1. Interest arising in a Contracting State and paid to a resident of another Contracting State shall be taxable only in that other State.

2. If a recipient of interest who is a resident of a Contracting State has a permanent establishment or a fixed base in a Contracting State other than the State of which he is a resident, and the debt-claim in respect of which the interest is paid is effectively connected with a business carried on from that permanent establishment, or with independent personal services performed from that fixed base, as the case may be, the interest arising in a Contracting State and paid to such a recipient shall, notwithstanding the provisions of paragraph 1, be taxed in accordance with the provisions of Article 7 or Article 14, as the case may be, in the Contracting State where the permanent establishment or fixed base is situated.

3. The term "interest" as used in this Article means income from debt-claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor's 'profits. The term comprises, in particular, income from government securities and income from bonds or debentures, including premiums and prizes attaching to such securities, bonds or debentures. Penalty charges for late payment shall not be regarded as interest for the purpose of this Article.

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

Article 12
Royalties

1. Royalties arising in a Contracting State and paid to a resident of another Contracting State shall be taxable only in that other State.

2. If a recipient of royalties who is a resident of a Contracting State has a permanent establishment or fixed base in a Contracting State other than the State of which he is a resident, and the right or property in respect of which the royalties are paid is effectively connected with a business carried on from that permanent establishment, or with independent personal services performed from that fixed base, as the case may be, the royalties arising in a Contracting State and paid to such a recipient may, notwithstanding the provisions of paragraph 1, be taxed in accordance with the provisions of Article 7 or Article 14, as the case may be, in the Contracting State where the permanent establishment or fixed base is situated.

3. The term "royalties" as used in this Article means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work (including cinematograph films and films and tapes for radio and television broadcasting), any patent, trade mark, design or model, plan, secret formula or process, or for the use of, or the right to use, industrial, commercial, or scientific equipment, or for information concerning industrial, commercial or scientific experience.

4. Where, by reason of a special relationship between the payer and the recipient or between both of them and some other person, the amount of the royalties, having regard to the use, right or information for

which they are paid, exceeds the amount which would have been agreed upon by the payer and the recipient in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In such case, the excess part of the payments shall remain taxable according to the laws of each Contracting State involved, due regard being had to the other provisions of this Convention.

Article 13
Capital gains

1. Gains derived by a resident of a Contracting State from the alienation of immovable property referred to in paragraph 2 of Article 6 and situated in another Contracting State may be taxed in that other State.

2. Gains derived by a resident of a Contracting State from the alienation of shares or other rights referred to in paragraph 4 of Article 6 may be taxed in the Contracting State in which the immovable property is situated.

3. Gains from the alienation of movable property forming part of the business property of a permanent establishment which an enterprise of a Contracting State has in another Contracting State or from the alienation of movable property pertaining to a fixed base available to a resident of a Contracting State in another Contracting State for the purpose of performing independent personal services, including such gains from the alienation of such a permanent establishment (alone or with the whole enterprise) or of such fixed base, may be taxed in that other State.

4. Gains from the alienation of ships or aircraft operated in international traffic or movable property pertaining to the operation of such ships or aircraft shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated. To the extent that such State is unable, under its law, to tax the entire gain, the gain shall be taxable only in the State of which the enterprise is a resident.

5. Gains from the alienation of any property other than that referred to in paragraphs 1 to 4, shall be taxable only in the Contracting State of which the alienator is a resident.

6. The provisions of paragraph 5 shall not affect the right of Norway to tax, in accordance with its own law, gains from the alienation of shares in a Norwegian company, if the shares are owned by a resident of another Contracting State who, at any time during the five years immediately preceding the alienation, has been a resident of Norway.

7. The provisions of paragraph 5 shall not affect the right of Sweden to tax, in accordance with its own law, gains derived by a resident of another Contracting State from the alienation of shares or other rights in companies, the essential assets of which consist of immovable property, if the person concerned has been a resident of Sweden at any time during the five years immediately preceding the alienation.

Article 14
Independent personal services

1. Income derived by a resident of a Contracting State in respect of professional services or other activities of an independent character shall be taxable only in that State unless he has a fixed base regularly available to him in another Contracting State for the purpose of performing his activities. If he has such a fixed base, the income may be taxed in that other State but only so much of it as is attributable to that fixed base.

2. The term "professional services" includes especially independent scientific, literary, artistic, educational, or teaching activities as well as the independent activities of physicians, lawyers, engineers, architects, dentists and accountants.

Article 15
Dependent personal services

1. Subject to the provisions of Articles 16, 18, 19, 20 and 21, salaries, wages and other similar remuneration derived by a resident of a Contracting State in respect of an employment shall be taxable only in that State unless the employment is exercised in another Contracting State. If the employment is exercised in that other State, such remuneration as is derived therefrom may be taxed therein.

2. Notwithstanding the provisions of paragraph 1, remuneration derived by a resident of a Contracting State in respect of an employment exercised in another Contracting State shall be taxable only in the first-mentioned State if:
a) the recipient is present in that other State for a period or periods not exceeding in the aggregate 183 days in the calendar year concerned; and
b) the remuneration is paid by, or on behalf of, an employer who is not a resident of that other State; and
c) the remuneration is not borne by a permanent establishment or a fixed base which the employer has in that other State.

3. Notwithstanding the foregoing provisions of this Article, remuneration derived in respect of work performed aboard:
a) a Danish, Finnish, Icelandic, Norwegian or Swedish ship shall be taxable only in the Contracting State of which the ship has the nationality; as regards the application of this provision, a foreign ship chartered on a "bareboat basis" by an enterprise of a Contracting State shall be considered as a Danish, Finnish, Icelandic, Norwegian or Swedish ship;
b) aircraft operated in international traffic shall be taxable only in the Contracting State of which the recipient of the remuneration is a resident;
c) a fishing, seal-hunting or whaling vessel shall be taxable only in the Contracting State of which the recipient of the remuneration is a resident, even in cases where the remuneration in respect of the work is paid in the form of a part or share in the profit of the fishing, seal-hunting or whaling business.

Article 16
Directors' fees

Directors' fees and similar payments derived by a resident of a Contracting State in his capacity as a member of the board of directors or similar body of a company which is a resident of another Contracting State may be taxed in that other State.

Article 17
Artistes and athletes

1. Notwithstanding the provisions of Articles 14 and 15, income derived by a resident of a Contracting State as an entertainer, such as a theatre, motion picture, radio or television artiste, or a musician, or as an athlete, from his personal activities as such exercised in another Contracting State, may be taxed in that other State.

2. Where income in respect of personal activities exercised by an entertainer or an athlete in his capacity as such accrues not to the entertainer or athlete himself but to another person, that income may, notwithstanding the provisions of Articles 7, 14 and 15, be taxed in the Contracting State in which the activities of the entertainer or athlete are exercised.

3. If the Contracting State in which the activities referred to in paragraphs 1 and 2 are exercised is unable, under its law, to tax the income concerned, the income may be taxed only in the Contracting State of which the recipient is a resident.

Article 18
Pensions, annuities and social security payments

1. Pensions and annuities paid from a Contracting State and payments made under the social security legislation of a Contracting State may be taxed only in that State.

2. The term "annuity" means a stated sum payable periodically at stated times during the life of the person insured, or during a specified or ascertainable period of time, under an obligation to make the payments in return for a corresponding full consideration in money or money's worth.

Article 19
Government service

1. Remuneration (excluding pensions) paid by a Contracting State, a political subdivision, a local authority, or a public institution thereof to an individual in respect of services rendered to that State, political subdivision, local authority or public institution shall be taxable only in that State.

2. However, such remuneration shall be taxable only in the Contracting State where the services are rendered if the recipient is a resident of that State, and:
a) is a national of that State; or
b) did not become a resident of that State solely for the purpose of rendering the services; or
c) cannot be taxed in respect of the remuneration in the State from which it is paid.

Article 20
Students and apprentices

1. A person who is visiting a Contracting State solely for the purpose of:
a) study at a university or other educational institution in that Contracting State; or
b) business, industrial, agricultural or forestry training in that Contracting State,

and who is, or immediately before his visit was, a resident of another Contracting State, shall not be taxed in the first-mentioned State in respect of payments received from sources outside that State for the purpose of his maintenance, education or training.

2. A person who is studying at a university or other educational institution in a Contracting State and who, during a temporary stay in another Contracting State holds an employment in that other State for a period not exceeding 100 days in a calendar year, for the purpose of obtaining practical experience in connection with his studies, shall be taxed in the last-mentioned Contracting State only for such part of the income from the employment as exceeds an average monthly income of 2,000 Swedish Crowns or its equivalent in Danish, Finnish, Icelandic or Norwegian currency. The exemption granted under this paragraph shall not, however, exceed an aggregate amount of 6,000 Swedish Crowns per calendar year or its equivalent in Danish, Finnish, Icelandic or Norwegian currency. The amounts stated above shall include the personal allowance for the calendar year in question.

3. The competent authorities of the Contracting States shall conclude agreements as regards the application of the provisions of paragraph 2. The competent authorities may also conclude agreements on such changes in the amounts mentioned in that paragraph as may be reasonable with regard to changes in the value of money, amended legislation in any of the Contracting States or any other similar circumstance.

Article 21
Business activities and dependent personal services offshore in a Contracting State

1. Subject to the provisions of paragraphs 2 and 3, a resident of a Contracting State who carries on business activities offshore in another Contracting State in connection with the exploration for and exploitation of natural resources in the seabed area of that other State shall be deemed to have a permanent establishment or fixed base in that other State.

2. The provisions of paragraph 1 shall not apply if the activities are carried on for a period or periods not exceeding in the aggregate 30 days in any 12-month period.

3. For the purposes of paragraph 2, an activity carried on by an enterprise which is associated with another enterprise shall be deemed to be carried on by the first-mentioned enterprise if its activity is substantially similar to the activity carried on by that other enterprise.[2] Enterprises shall be regarded as associated if one enterprise participates directly or indirectly in the management, control or capital of the other enterprise or if the same persons participate directly or indirectly in the management, control or capital of both enterprises.

4. The provisions of paragraph 1 of Article 8 shall apply to profits from the transportation of personnel and supplies by ships or aircraft to a seabed area as referred to in paragraph 1, or from the operation of tugboats, supply ships or other vessels used for similar purposes in connection with activities referred to in that paragraph.

5. The provisions of paragraph 4 of Article 13 and paragraph 3 of Article 23 shall apply, respectively, to gains from the alienation of ships, boats and aircraft referred to in paragraph 4, and to capital consisting of such ships, boats and aircraft.

6. Notwithstanding any other provision of this Convention, the following provisions shall apply as regards the taxation of wages and other similar remuneration derived by a resident of a Contracting State in respect of work performed offshore in another Contracting State for an employer carrying on activities as referred to in paragraph 1:
a) Subject to the provisions of sub-paragraphs b) to d), such remuneration may be taxed in that other State, but only if the work is performed in that State for a period or periods exceeding in the aggregate 30 days in any 12-month period.
b) Such remuneration shall be taxable only in the first-mentioned Contracting State, where:
   1) the work is connected with the exploitation of oil fields situated on the dividing line between a Contracting State and a third state;
   2) these two States have entered into an agreement relating to the joint exploitation of the oil fields; and
   3) the exploitation is undertaken on both sides of the dividing line simultaneously.

   The provisions of this sub-paragraph shall apply only by agreement between the competent authorities of the Contracting States.
c) Such remuneration shall be taxed in accordance with the provisions of paragraph 3a) of Article 15 if the work is performed aboard a boat or ship as referred to in paragraph 4 of this Article.
d) Such remuneration shall be taxable only in the State in which the place of effective management of the enterprise is situated, if the work is performed aboard an aircraft as referred to in paragraph 4 of this Article.

7. In this Article the term "seabed area" means the seabed and subsoil within the territorial waters of a Contracting State and the Continental Shelf area of that State.

Article 22
Other income

1. Items of income of a resident of a Contracting State, wherever arising, not dealt with in the foregoing Articles of this Convention shall be taxable only in that State.

2. The provisions of paragraph 1 shall not apply if the recipient is a resident of a Contracting State and has a permanent establishment or a fixed base in another Contracting State and the right or property in respect of which the income arises is effectively connected with the business carried on from that permanent establishment, or with independent personal services performed from that fixed base, as the case may be. In such cases, the provisions of Article 7 or Article 14, respectively, shall apply. However, where immovable property, as referred to in paragraph 2 of Article 6, or a share or other corporate right, as referred to in paragraph 4 of Article 6, belongs to a permanent establishment or a fixed base, the income from such property or share shall be taxed in accordance with the provisions of Article 6.

Article 23
Capital

1. Immovable property as referred to in paragraph 2 of Article 6, owned by a resident of a Contracting State and situated in another Contracting State, may be taxed in that other State.

2. Shares and other corporate rights in a company as referred to in paragraph 4 of Article 6, owned by a resident of a Contracting State, may be taxed in the Contracting State where the immovable property is situated.

3. Ship and aircraft operated in international traffic and movable property pertaining to the operation of such ships and aircraft shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated. To the extent that such State is unable, under its law, to tax the entire property, the capital shall be taxable only in the State of which the enterprise is a resident.

4. All other elements of capital, wherever situated, owned by a resident of a Contracting State shall be taxable only in that State.

5. Notwithstanding the provisions of paragraph 4, movable property forming part of the business property of a permanent establishment which an enterprise of a Contracting State has in another Contracting State, or movable property pertaining to a fixed base which a resident of a Contracting State has in another Contracting State with a view to the performing of independent personal services, shall be taxable in that other State.

Article 24
Estates of deceased persons

Income or capital taxed in the hands of an

2. This provision, as translated from the Danish, Norwegian and Swedish originals, does not, it seems, reflect the real intention of the draftsmen. It is our opinion that the provision intends to state that the activities of the "other enterprise" should be deemed to be carried on by the first-mentioned enterprise (translator's note).

estate of a deceased person which is a resident of a Contracting State may not be taxed in the hands of persons entitled to a share in the estate who are residents of another Contracting State.

Article 25
Elimination of double taxation

1. *Denmark*
a) Where a resident of Denmark derives income or owns capital which, in accordance with the provisions of this Convention, may be taxed in another Contracting State, Denmark shall, subject to the provisions of paragraph 8, second sentence, of Article 10 and paragraph b) below, allow:
   1) as a deduction from the Danish tax on the income of that resident, an amount equal to the income tax paid in that other Contracting State;
   2) as a deduction from the Danish tax on the capital of that resident, an amount equal to the capital tax paid in that other Contracting State.

   Such deduction in either case shall not, however, exceed that part of the Danish income tax or capital tax, as computed before the deduction is given, which is payable in respect of the income or capital which may be taxed in that other State.
b) Where a resident of Denmark derives income or owns capital which, in accordance with the provisions of this Convention, shall be taxable only in another Contracting State, Denmark may include such income or capital in the tax base, but shall allow as a deduction from the Danish tax on income or capital that part of the income tax or capital tax, as the case may be, which is payable in respect of the income derived from that other State, or the capital owned in that other State.

2. *Finland*
a) Where a resident of Finland derives income or owns capital which, in accordance with the provisions of this Convention, may be taxed in another Contracting State, Finland shall, subject to the provisions of paragraph 8, first sentence, of Article 10 and paragraph b) below, allow:
   1) as a deduction from the Finnish tax on the income of that resident, an amount equal to the income tax paid in that other Contracting State;
   2) as a deduction from the Finnish tax on the capital of that resident, an amount equal to the capital tax paid in that other Contracting State.

   Such deduction in either case shall not, however, exceed that part of the Finnish income tax or capital tax, as computed before the deduction is given, which is payable in respect of the income or capital which may be taxed in that other State.
b) Where a resident of Finland derives income or owns capital which, in accordance with the provisions of this Convention, shall be taxable only in another Contracting State, Finland may include such income or capital in the tax base, but shall allow as a deduction from the Finnish tax on income or capital that part of the income tax or capital tax, as the case may be, which is payable in respect of the income derived from that other State, or the capital owned in that other State.

3. *Iceland*
a) Where a resident of Iceland derives income or owns capital which, in accordance with the provisions of this Convention, may be taxed in another Contracting State, Iceland shall, subject to the provisions of paragraphs b) and c) below, exempt such income or capital from tax.
b) Where a resident of Iceland derives income which, in accordance with the provisions of Article 10, may be taxed in another Contracting State, Iceland shall, subject to the provisions of paragraph 8, first sentence, of that Article allow as a deduction from the Icelandic income tax an amount equal to the income tax paid in that other Contracting State. Such deduction shall not, however, exceed that part of the Icelandic tax, as computed before the deduction is given, which is payable in respect of the income which may be taxed in that other State.
c) Where in accordance with any provision of the Convention income derived or capital owned by a resident of Iceland is exempt from tax in that State, Iceland may nevertheless, in calculating the Icelandic tax on the remaining income or capital of such resident, take into account the exempted income or capital.

4. *Norway*
a) Where a resident of Norway derives income or owns capital which, in accordance with the provisions of this Convention, may be taxed in another Contracting State, Norway shall, subject to the provisions of paragraphs b), c) and d) below, exempt such income or capital from tax.
b) Where a resident of Norway derives income which, in accordance with the provisions of Articles 10 and 21, may be taxed in another Contracting State, Norway shall, subject to the provisions of paragraph 8, first sentence, of Article 10 allow as a deduction from the Norwegian income tax of that resident an amount equal to the income tax paid in that other Contracting State. Such deduction shall not, however, exceed that part of the Norwegian tax, as computed before the deduction is given, which is payable in respect of the income which may be taxed in that other State.
c) Where in accordance with any provision of the Convention income derived or capital owned by a resident of Norway is exempt from tax in that State, Norway may nevertheless, in calculating the Norwegian tax on the remaining income or capital of such resident, take into account the exempted income or capital.
d) Where a resident of a Contracting State derives gains, referred to in paragraph 6 of Article 13, which may be taxed in Norway, Norway shall allow as a deduction from the Norwegian income tax of that person an amount equal to the tax paid in that other Contracting State in respect of such gains. Such deduction shall not, however, exceed that part of the Norwegian tax, as computed before the deduction is given, which is payable in respect of the gains.

5. *Sweden*
a) Where a resident of Sweden derives income or owns capital which, in accordance with the provisions of this Convention, may be taxed in another Contracting State, Sweden shall, subject to the provisions of paragraph 8, first sentence, of Article 10 and paragraphs b), c) and d) below, allow:
   1) as a deduction from the Swedish tax on the income of that resident, an amount equal to the income tax paid in that other Contracting State;
   2) as a deduction from the Swedish tax on the capital of that resident, an amount equal to the capital tax paid in that other Contracting State.

   Such deduction in either case shall not, however, exceed that part of the Swedish income tax or capital tax, as computed before the deduction is given, which is payable in respect of the income or capital which may be taxed in that other State.
b) As regards the application of sub-paragraph a), where under special legislation relief from Finnish income tax or capital tax is given in respect of a permanent establishment which a Swedish enterprise has in Finland, such amount of income tax or capital tax, as the case may be, shall be deducted from the Swedish tax on the income or capital of the enterprise as would have been payable in Finland if no such relief had been given.
c) Where a resident of Sweden derives income or owns capital which, in accordance with the provisions of this Convention, shall be taxable only in another Contracting State, Sweden may include the income or capital in the tax base, but shall allow as a deduction from the Swedish tax on income or capital that part of the income tax or capital tax, as the case may be, which is payable in respect of the income derived from that other State, or the capital owned in that other State.
d) Where a resident of a Contracting State derives gains, referred to in paragraph 7 of Article 13, which may be taxed in Sweden, Sweden shall allow as a deduction from the Swedish income tax of that person an amount equal to the tax paid on the gains in that other Contracting State. Such deduction shall not, however, exceed that part of the Swedish tax, as computed

before the deduction is given, which is payable in respect of the gains.

Article 26
Limitation of taxing rights

Income derived by a resident of a Contracting State or capital owned by such resident may not be taxed in another Contracting State, unless taxation is explicitly allowed under this Convention.

Article 27
Non-discrimination

1. Nationals of a Contracting State shall not be subjected in another Contracting State to any taxation or any requirement connected therewith, which is other or more burdensome than the taxation and connected requirements to which nationals of that other State in the same circumstances are or may be subjected. This provision shall, notwithstanding the provisions of Article 1, also apply to persons who are not residents of one or more of the Contracting States.

2. The taxation on a permanent establishment or a fixed base which an enterprise or resident of one of the Contracting States has in another Contracting State shall not be less favourably levied in that other State than the taxation on enterprises or residents of that other State carrying on the same activities.

This provision shall not be construed as obliging a Contracting State to grant to residents of another Contracting State any personal allowances, reliefs and reductions for taxation purposes on account of civil status or family responsibilities which it grants to its own residents. Neither does the provision grant any right to obtain in a Contracting State a deduction or exemption for taxation purposes in respect of dividends and other distributions to a company resident in another Contracting State.

The provisions of the first sentence also shall not prevent a Contracting State from taxing income derived by a permanent establishment in accordance with the provisions of its own laws, if that permanent establishment is owned by a company limited by shares or a comparable company in another Contracting State. However, the taxation shall be equal to the taxation levied on companies limited by shares and comparable companies which are residents of the first-mentioned Contracting State, in respect of their income as computed without any deduction being given for distributed profits.

3. Except where the provisions of paragraph 1 of Article 9, paragraph 4 of Article 11, or paragraph 4 of Article 12, apply, interest, royalties and other disbursements paid by an enterprise of a Contracting State to a resident of another Contracting State shall, for the purpose of determining the taxable profits of such enterprise, be deductible under the same conditions as if they had been paid to a resident of the first-mentioned State. Similarly, any debts of an enterprise of a Contracting State to a resident of another Contracting State shall, for the purpose of determining the taxable capital of such enterprise, be deductible under the same conditions as debts to a resident of the first-mentioned State.

4. Enterprises of a Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of one or more of the other Contracting States, shall not be subjected in the first-mentioned State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which other similar enterprises of the first-mentioned State are or may be subjected.

5. The provisions of this Article shall not be construed as obliging Norway to grant to nationals of another Contracting State who were not born in Norway of Norwegian parents the exceptional tax relief which under paragraph 22 of the Tax Act of 18 August 1911 is accorded to nationals of Norway and individuals born in Norway of Norwegian parents (individuals having Norwegian "innfødsrett").

6. The provisions of this Article shall, notwithstanding the provisions of Article 2, apply to taxes of every kind and description.

Article 28
Mutual agreement procedure

1. Where a person considers that the actions of one or more of the Contracting States result or will result for him in taxation not in accordance with the provisions of this Convention, he may, irrespective of the remedies provided by the domestic law of those States, present his case to the competent authority of the Contracting State of which he is a resident or, if his case comes under paragraph 1 of Article 27, to that of the Contracting State of which he is a national.

2. The competent authority shall endeavour, if the objection appears to it to be justified and if it is not itself able to arrive at a satisfactory solution, to resolve the case by mutual agreement with the competent authority of the other Contracting State involved in the issue, with a view to the avoidance of taxation which is not in accordance with the Convention. If the State, to the competent authority of which the person in question has presented his case, is not itself involved in the issue, that competent authority shall hand over the case to the competent authority of any of the States which is or are involved in the issue.

3. Where any difficulties or doubts arise between Contracting States as to the interpretation or application of the Convention, the competent authorities of these States shall consult together in order to try and resolve the issue by special agreement. In addition, the competent authorities of the Contracting States may consult together for the elimination of double taxation in cases not provided for in this Convention or in order to resolve, by special agreement, any issues which – without being provided for by the Convention – may arise in respect of the taxes referred to in Article 2, as a result of disparities between the principles governing the computation of tax in the States concerned, or any other reason.

Before a decision on any issue, as referred to in the first sub-paragraph, is taken, the outcome of the consultations referred to shall be communicated to the competent authorities of the other Contracting States as soon as possible. If the competent authority of a Contracting State considers that consultations should take place between the competent authorities of all Contracting States, such consultations shall take place without delay at the request of the competent authority of the first-mentioned Contracting State.

Article 29
Diplomatic agents and consular officers

The provisions of this Convention shall not affect the fiscal privileges of diplomatic agents or consular officers under the general rules of international law or under the provisions of special agreements.

Article 30
Territorial extension

1. This Convention may be extended, either in its entirety or with any necessary modifications, to the territories which under paragraph 1a) of Article 3 are excluded from the application of the Convention, on the condition that in those territories taxes are imposed which are substantially similar in character to those to which the Convention applies. Any such extension shall take effect from such date and subject to such modifications and conditions, including provisions as to termination, as may be specifically agreed between the Contracting States in notes to be exchanged through diplomatic channels.

2. Where this Convention is terminated in accordance with Article 32, the Convention shall, unless otherwise agreed by the Contracting States, also be terminated in respect of the territories to which it has been extended under this Article.

Article 31
Entry into force

1. This Convention shall enter into force thirty days after the date on which all Contracting States have informed the Finnish Ministry of Foreign Affairs that all steps necessary for the entry into force of the Convention in that particular State have been taken. The Finnish Ministry of Foreign Affairs shall notify the other Contracting States of the receipt of such information.

2. Upon the entry into force of the Convention it shall have effect in respect of income derived on or after 1 January immediately following the entry into force, and in respect of capital assessed to tax for the second calendar year after the entry into force and subsequent years.

3. The following Conventions shall be terminated and shall no longer be effective in respect of income and capital for which the present Convention, in accordance with paragraph 2, has effect:
- the Convention of 19 October 1925 be-

tween the Kingdom of Denmark and the Republic of Finland concerning the exemption from municipal income tax for certain persons;
- the Convention of 22 February 1957 between the Kingdom of Denmark and the Kingdom of Norway for the avoidance of double taxation with respect to taxes on income and on capital, as amended;
- the Convention of 23 January 1964 between the Republic of Iceland and the Kingdom of Sweden for the avoidance of double taxation with respect to taxes on income and on capital;
- the Convention of 7 April 1964 between the Kingdom of Denmark and the Republic of Finland for the avoidance of double taxation of income and capital and the prevention of fiscal evasion, as amended;
- the Convention of 30 March 1966 between the Republic of Iceland and the Kingdom of Norway for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and on capital, as amended;
- the Convention of 21 May 1970 between the Kingdom of Denmark and the Republic of Iceland for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and on capital, as amended;
- the Convention of 1 November 1971 between the Kingdom of Norway and the Kingdom of Sweden for the avoidance of double taxation with respect to taxes on income and on capital;
- the Convention of 12 January 1972 between the Republic of Finland and the Kingdom of Norway for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and on capital;
- the Convention of 2 March 1972 between the Republic of Finland and the Republic of Iceland for the avoidance of double taxation of income and capital and the prevention of fiscal evasion;
- the Convention of 27 June 1973 between the Government of the Republic of Finland and the Government of the Kingdom of Sweden for the avoidance of double taxation with respect to taxes on income and on capital, as amended;
- the Convention of 16 November 1973 between the Government of the Kingdom of Denmark and the Government of the Kingdom of Sweden for the avoidance of double taxation with respect to taxes on income and on capital.

Article 32
Termination

This Convention shall remain in force indefinitely, but any Contracting State may terminate the Convention, through diplomatic channels, by giving notice to each of the other Contracting States at least six months before the end of any calendar year. If the time limit for giving such notice is observed, the Convention shall cease to be effective in the relationship between the State which has given notice of termination and the other Contracting States:

a) in respect of income derived on or after 1 January of the year immediately following the year in which the termination has taken place; and
b) in respect of capital assessed to tax for the second calendar year following the year in which the termination has taken place and subsequent years.

This Convention shall be deposited with the Finnish Ministry of Foreign Affairs and certified copies shall be transmitted by the Finnish Ministry of Foreign Affairs to the Governments of all the other Contracting States.

In witness whereof the undersigned, duly authorised thereto, have signed this Convention.

Done at Helsinki, this twenty-second day of March 1983, in the Danish, Finnish, Icelandic, Norwegian and Swedish languages, there being two texts in Swedish, one for Finland and one for Sweden, all texts being equally authentic.

Kjeld Mortensen
Jermu Laine
Sigurbjörn Thorbjörnsson
Ö. Bucher-Johannessen
Kaj Sundberg

PROTOCOL

At the signing of the Convention concluded today between the Governments of Denmark, Finland, Iceland, Norway and Sweden for the avoidance of double taxation with respect to taxes on income and on capital, the undersigned have agreed upon the following provisions which shall form an integral part of the Convention

I. With reference to Article 5

Where an enterprise of a Contracting State has several building sites or construction or installation projects in another Contracting State simultaneously and the work in any of them lasts more than 12 months, the competent authorities of those States may endeavour to decide by agreement whether those sites together constitute a permanent establishment in that other Contracting State.

The same shall apply where an enterprise of a Contracting State has several building sites or construction or installation projects in another State in succession and the work lasts, in the aggregate, more than 12 months.

II. With reference to Articles 7 and 15

1. Notwithstanding the provisions of Article 7, profits derived by an enterprise of Norway or an enterprise of Sweden from a business carried on in Sweden or Norway, respectively, shall be taxable only in the State of which the enterprise is a resident, if the business is concerned with the erection and maintenance of fences for reindeer along the sections of the Norwegian–Swedish frontier as determined in an agreement under paragraph 4.

2. Notwithstanding the provisions of Article 15, income derived by a resident of Norway or Sweden in respect of an employment exercised in Sweden or Norway, respectively, shall be taxable only in the State of which that person is a resident, if the employment is concerned with the erection and maintenance of fences for reindeer along the sections of the Norwegian–Swedish frontier as determined in an agreement under paragraph 4.

3. The provisions of paragraphs 1 and 2 concerning enterprises and residents, respectively, of Norway or Sweden shall equally apply in respect of enterprises and residents, respectively, of Finland or Norway.

4. The competent authorities of the Contracting States involved shall by mutual agreement determine the sections of the respective frontiers to which the provisions of paragraphs 1 to 3 shall apply.

III. With reference to Articles 7, 10 to 15, 19, 20 and 23

1. Notwithstanding the provisions of Article 7, paragraph 2 of Article 10, paragraph 2 of Article 11 and paragraph 2 of Article 12, profits derived by an enterprise of Denmark or Sweden in respect of the construction and operation of fixed connections across the Øresund shall be taxable only in the State of which the enterprise is a resident.

2. Notwithstanding the provisions of paragraph 3 of Article 13, gains derived by an enterprise or resident of Denmark or Sweden from the alienation of property referred to in that paragraph, which is used for the construction and operation of fixed connections across the Øresund, shall be taxable only in the State of which that enterprise or person, as the case may be, is a resident.

3. Notwithstanding the provisions of paragraph 1 of Article 14, paragraph 1 of Article 15, Article 19 and Article 20, income derived by a resident of Denmark or Sweden in respect of the construction and operation of fixed connections across the Øresund shall be taxable only in the State of which that person is a resident.

4. Notwithstanding the provisions of paragraph 5 of Article 23, property referred to in that paragraph which is owned by an enterprise or resident of Denmark or Sweden and used for the construction and operation of fixed connections across the Øresund shall be taxable only in the State of which that enterprise or person, as the case may be, is a resident.

IV. With reference to Articles 8, 13, 15 and 23

1. With respect to the partners in the consortium Scandinavian Airlines System (SAS), the provisions of paragraph 1 of Article 8, paragraph 4 of Article 13 and paragraph 3 of Article 23, shall apply in Denmark, Norway and Sweden to such parts of the profits and capital gains derived and property owned by the consortium as correspond to the shares which the partners own in the consortium.

2. The provisions of paragraph 3b) of Article 15 shall also apply to remuneration derived in respect of work performed aboard aircraft operated in inland traffic by the consortium Scandinavian Airlines System (SAS).

V. With reference to Articles 8, 13 and 23

A share in the profits of a business, as referred to in paragraph 1 of Article 8, a share in the gains from the alienation of items of property, as referred to in paragraph 4 of Article 13, and a share in property, as referred to in paragraph 3 of Article 23, which a resident of a Contracting State derives or owns as participant in an enterprise shall be taxable only in that State if:

a) the participants are residents of different Contracting States;
b) the enterprise is carried on by a company or other entity having participants who are jointly and severally liable, at least one of them also having unlimited liability; and
c) it is not evident that the enterprise has its place of effective management in one Contracting State only.

The competent authorities of the Contracting States may conclude an agreement concerning the application of the taxation principles laid down in the first sub-paragraph also to cases where the conditions set out in that sub-paragraph are not satisfied.

VI. With reference to Article 12

When a provision entitling Finland to tax "industrial royalties" paid from Finland has been included in the conventions for the avoidance of double taxation with respect to taxes on income and on capital which Finland has concluded with the majority of the industrialized Member States of the Organisation for Economic Co-operation and Development (OECD), negotiations between the Contracting States shall be initiated as soon as possible with a view to establishing a similar right for the Contracting State from which the royalties are derived as against the other Contracting States.

VII. With reference to Article 15

Notwithstanding the provisions of paragraphs 1 and 2 of Article 15, income derived by a resident of a municipalitiy in Finland, Norway or Sweden which borders upon the land frontier between Finland and Sweden, or Finland and Norway, as the case may be, in respect of work performed in such a municipality situated in another of these States, shall be taxable only in the State of which the person in question is a resident, provided that such person is regularly present at his permanent address in that State.

The expression "is regularly present" means that the taxpayer is normally present at least once every week at his permanent address in the Contracting State of which he is a resident.

VIII. With reference to Articles 15 and 19

Notwithstanding the provisions of paragraphs 1 and 2 of Article 15 and paragraph 1 of Article 19, income derived by a resident of a municipality in Norway or Sweden which borders upon the land frontier between these States, in respect of work performed in such a municipality situated in the other of these States, shall be taxable only in the State of which the person in question is a resident, provided that such person is regularly present at his permanent address in that State.

The expression "is regularly present" means that the taxpayer is normally present at least once every week at his permanent address in the State of which he is a resident.

IX. With reference to Articles 18 and 19

To the extent that Norway is unable, under its law, to tax income dealt with in Articles 18 and 19, such income shall be taxable only in the Contracting State of which the recipient is a resident.

X. With reference to Article 20

1. A person who is present in a Contracting State other than Iceland solely for the purpose of:

a) study at a university or other educational institution in that Contracting State; or
b) business, industrial, agricultural or forestry training in that Contracting State,

and who is, or immediately before his stay was, a resident of Iceland shall, in respect of income from employment in the first-mentioned Contracting State, be taxed only for such part of that income as exceeds 20,000 Swedish Crowns per calendar year, or its equivalent in Danish, Finnish, Icelandic or Norwegian currency. The amount stated above shall, during educational stays in Finland, Norway or Sweden, include the personal allowance for the calendar year in question.

If, during an educational stay in Denmark, a higher amount for the maintenance of the person in question is considered necessary under prevailing conditions, such higher amount shall be exempt from Danish tax. However, the latter provision shall not apply where the study or education is of secondary importance as compared to the services for which the remuneration is paid.

2. The exemption referred to in paragraph 1 shall be allowed only for a period of time which reasonably or normally is needed for the study or training, subject to a maximum of six consecutive calendar years.

3. The competent authorities of the Contracting States shall conclude agreements as regards the application of the provisions of paragraphs 1 and 2. The competent authorities may also conclude agreements on such changes in the amounts mentioned in those paragraphs as may be reasonable with regard to changes in the value of money, amended legislation in any of the Contracting States or any other similar circumstance.

XI. With reference to Article 25

1. At the request of Iceland, paragraph 3 of Article 25 may be changed and replaced by the following text:

"a) Where a resident of Iceland derives income or owns capital which, in accordance with the provisions of this Convention, may be taxed in another Contracting State, Iceland shall, subject to the provisions of paragraph 8, first sentence, of Article 10 and paragraph b) below, allow:
   1) as a deduction from the Icelandic tax on the income of that resident, an amount equal to the income tax paid in that other Contracting State;
   2) as a deduction from the Icelandic tax on the capital of that resident, an amount equal to the capital tax paid in that other Contracting State.

   Such deduction in either case shall not, however, exceed that part of the Icelandic income tax or capital tax, as computed before the deduction is given, which is payable in respect of the income or capital which may be taxed in that other State.

b) Where a resident of Iceland derives income or owns capital which, in accordance with the provisions of this Convention, shall be taxable only in another Contracting State, Iceland may include such income or capital in the tax base, but shall allow as a deduction from the Icelandic tax on income or capital that part of the income tax or capital tax, as the case may be, which is payable in respect of the income derived from that other State, or the capital owned in that other State."

The request for such change shall be made through diplomatic channels, by giving notice to each of the other Contracting States. The change shall enter into force thirty days after the date on which all other Contracting States have received such notice, and its provisions shall thereupon have effect:

a) with respect to taxes on income derived on or after 1 January immediately following such notice; and
b) with respect to taxes on capital payable on assessments for the second calendar year following the year in which such notice is given and subsequent years.

2. At the request of Norway, paragraph 4 of Article 25, may be changed and replaced by the following text:

"a) Where a resident of Norway derives income or owns capital which, in accordance with the provisions of this Convention, may be taxed in another Contracting State, Norway shall, subject to the provisions of paragraph 8, first sentence, of Article 10 and paragraphs b) and c) below, allow:
   1) as a deduction from the Norwegian tax on the income of that resident, an amount equal to the income tax paid in that other Contracting State;
   2) as a deduction from the Norwegian tax on the capital of that res-

ident, an amount equal to the capital tax paid in that other Contracting State.

Such deduction in either case shall not, however, exceed that part of the Norwegian income tax or capital tax, as computed before the deduction is given, which is payable in respect of the income or capital which may be taxed in that other State.

b) Where a resident of Norway derives income or owns capital which, in accordance with the provisions of this Convention, shall be taxable only in another Contracting State, Norway may include such income or capital in the tax base, but shall allow as a deduction from the Norwegian tax on income or capital that part of the income tax or capital tax, as the case may be, which is payable in respect of the income derived from that other State, or the capital owned in that other State.

c) Where a resident of a Contracting State derives gains referred to in paragraph 6 of Article 13, which may be taxed in Norway, Norway shall allow as a deduction from the Norwegian income tax of that person an amount equal to the tax paid in the other Contracting State in respect of such gains. Such deduction shall not, however, exceed that part of the Norwegian tax, as computed before the deduction is given, which is payable in respect of the gains."

The request for such change shall be made through diplomatic channels, by giving notice to each of the other Contracting States. The change shall enter into force thirty days after the date on which all other Contracting States have received such notice, and its provisions shall thereupon have effect:

a) with respect to taxes on income derived on or after 1 January immediately following such notice; and

b) with respect to taxes on capital payable on assessments for the second calendar year following the year in which such notice is given and subsequent years.

XII. With reference to Article 31

1. Notwithstanding the provisions of paragraphs 2 and 3 of Article 31, paragraph 4 of Article 15 of the Convention of 16 November 1973 between the Government of the Kingdom of Denmark and the Government of the Kingdom of Sweden for the avoidance of double taxation with respect to taxes on income and on capital shall continue to apply and its provisions shall have effect with respect to income derived before the end of the third calendar year following the year in which the present Convention has entered into force.

After the expiration of the period stated in the first sentence, the provisions of the Convention of 16 November 1973 mentioned in that sentence shall be terminated.

The provisions of the Convention of 16 November mentioned in the first sentence read as follows:

"Notwithstanding the provisions of paragraphs 1 and 2, income derived by so-called frontier workers who are residents of a Contracting State in respect of work performed in the other Contracting State shall be taxable only in the first-mentioned Contracting State. For the purpose of this provision a frontier worker means an employee who is regularly present at his permanent address in the Contracting State of which he is a resident but who normally works in the other Contracting State."

2. The exemptions granted in Finland and Sweden to associations of raftsmen established for the purpose of carrying on rafting on the rafting routes in the border rivers Torne and Muonio shall be governed by a special agreement.

3. The basis for the apportionment between Norway and Sweden of taxing rights concerning Luossavaara-Kiirunavaara A.B. shall be determined by a special agreement.

This Protocol shall be deposited with the Finnish Ministry of Foreign Affairs and certified copies shall be transmitted by the Finnish Ministry of Foreign Affairs to the Governments of all the other Contracting States.

In witness whereof the undersigned, duly authorised thereto, have signed this Protocol.

Done at Helsinki, this twenty-second day of March 1983, in the Danish, Finnish, Icelandic, Norwegian and Swedish languages, there being two texts in Swedish, one for Finland and one for Sweden, all texts being equally authentic.

Kjeld Mortensen
Jermu Laine
Sigurbjörn Thorbjörnsson
O. Bucher-Johannessen
Kaj Sundberg.

U.S.A.:

Effect of the 1985-1986 U.S. Tax Reform Bill on Foreign Investments in U.S. Real Estate

By Christine Halphen*

I. INTRODUCTION

On 17 December 1985, the U.S. House of Representatives passed H.R. 3838, the 1985-1986 tax reform bill (referred to as the "House bill" or HR 3838 throughout the following discussion). On the Senate side, the Senate Finance Committee is elaborating its own version of a tax reform bill, believed to be largely inspired from the House bill and also from the President's Tax Proposals to the Congress, published in May 1985. Despite generally negative reactions from industry-related groups and eonomists it is anticipated that a tax reform bill has a good chance of passage this year, although the Senate version may differ substantially from the House bill in key issues. After passage of the Senate bill in the Senate, a final version would have to be elaborated in a House-Senate conference. The final bill passed by both the House and the Senate requires the President's signature before it becomes law. Although the President may veto the bill, this appears unlikely unless the bill fails to achieve major goals he has set (such as no overall tax increase, low tax rates for individuals, and probably, no consumption tax). In the meantime, according to the normal U.S. legislative process, the House bill and the version elaborated in the Senate Finance Committee will remain open for modifications, additions, and deletions.

The House bill is the result of efforts on the part of the U.S. Treasury Department and Congress to accomplish a fundamental tax reform of the U.S. tax system for greater simplicity, fairness and economic growth. While the House bill proposes rather fundamental changes in a number of important areas, it does not simplify Federal taxes for corporations and, at least in the case of real estate, is neither fairer to foreign investors nor growth-oriented. Overall, the House bill is revenue neutral, shifting approximately US$ 138 billion of tax burden from individuals to corporations on a 5-year basis. However, over the same period the House bill gains over US$ 11 billion in revenues from changes in the foreign provisions.

The House bill includes measures which would substantially increase the U.S. tax burden on most foreign investment in U.S. real estate, generally effective in 1986, although consideration is being given to postpone effective dates until 1987. This seems to confirm a trend to burden such investments with increased U.S. taxation.

II. EFFECT ON FIRPTA TAX

For many years, foreign-owned U.S. real estate was taxed like most other foreign-owned U.S. investments (i.e., tax on operating income; no tax on disposition, generally). In 1980, Congress passed the Foreign Investment in U.S. Real Property Tax Act 1980 (FIRPTA) imposing what is often referred to as the "FIRPTA" tax (i.e. a tax on gains realized by foreign investors on the disposition of U.S. real estate). As a result, foreign-owned U.S. real estate became taxed more heavily than other forms of foreign-owned U.S. investments and, in many cases, more heavily than U.S.-owned U.S. real estate.

H.R. 3838 aggravates the U.S. tax burden resulting from the FIRPTA tax in a number of ways:

A. *Like their domestic counterparts,* foreign investors in U.S. real estate would suffer, principally:
- in cases where the investors are corporations, from a substantial increase in the rate of the FIRPTA tax, because the maximum tax rate imposed on corporate long-term capital gain would increase from 28% to 36%;[1] in the case of individuals, the House bill retains a lower rate for long-term capital gains, but increases the rate from 20% to 22%;
- from a greater tax burden on operating income due primarily to less generous depreciation rules, the repeal of the investment tax credit (of limited but some applicability to real estate) and the reductions in the rehabilitation credits;[2]
- from a greater tax due to the broadening of the corporate minimum tax;
- from the extension of the "at-risk" rules to real estate activities;
- from new restrictions imposed on pledging installment sales notes;
- from the repeal of certain tax-free liquidation pro-

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1. Aside from the increase in tax on dispositions, the substantial broadening of the tax base for real estate investments would not always be compensated for by the reduction of the maximum corporate income tax rate from 46% to 36% with the result that a tax might arise under the proposed rules where there would be a lower tax or an operating loss under present law.

2. Under present law, those tax benefits tend to substantially reduce taxable operating income, at least in the early stages of an investment, and, because of the loss carryovers, may lower the effective tax rate on long-term capital gains below the maximum 28% rate (or 20% rate in case of individuals).

visions, the main effect of which would be to virtually eliminate the possibility for individual investors, owning their real estate in corporate form, to be taxed on long-term capital gains at the 22% new maximum individual rate rather than the 36% new maximum corporate rate.

B. *Unlike their domestic counterparts,* many foreign investors in U.S. real estate would suffer from the proposed 30% branch tax on the repatriated profits of foreign corporations which are effectively connected with a U.S. trade or business or are deemed to be so connected. The tax would apply in addition to the FIRPTA tax on the profits from the sale by a foreign corporation of U.S. real estate, or, it would even seem, of an interest in a U.S. corporation or other entity owning U.S. real estate. The branch tax would raise the maximum 36% rate on income and gains from a U.S. real estate investment to an effective rate as high as 55%. Because it would also apply to certain interest expense of foreign corporations, the proposed branch-level tax would greatly affect the manner in which the financing of real estate investments is structured. Foreign investors residing in a country which has a tax treaty with the United States may be protected from the branch tax although the House bill contains certain broad treaty override provisions, particularly designed to restrict perceived abuses from uses of tax treaties by third-country residents (so-called "treaty shopping").

If those changes are enacted, many foreign individual investors (especially those not resident in a country which has a tax treaty with the United States) may find the corporate ownership of U.S. real estate too onerous and consider debt-financing deals rather than equity deals. Individuals might consider alternative investments owned directly by them or through parnerships or trusts. Also, because of special benefits, Real Estate Investment Trusts (REITS) may regain their pre-FIRPTA popularity as a vehicle for investment in U.S. real estate. Those structures, however, would generally expose the foreign individual investor to the U.S. estate tax. Foreign corporate investors, including institutional investors, may have less flexibility in minimizing the impact of the branch tax. Options would include debt-financing deals or U.S. real estate ownership through U.S. corporate structures.

Overall, while there are still planning opportunities for reducing the FIRPTA tax, those proposed changes, and particularly the branch tax, would make such planning more difficult. In view of the proposed changes, pressures to obtain a repeal of FIRPTA are likely to increase as well as efforts to prevent the imposition of a branch tax.

III. H.R. 3838 Provisions

Below is an overview of significant provisions in H.R. 3838 affecting foreign investors in U.S. real estate. The reader should be cautioned that the purpose here is to highlight important changes affecting typical real estate investments. For instance, no attempt is made to discuss oil and gas investments or the treatment of timber.

A. Increase in capital gains rates (Secs. 301 and 302 of the House bill; I.R.C. Secs. 11 and 1201[3])

Under current law, foreign corporations that derive long-term capital gains[4] on the disposition of their U.S. real estate investments are taxed at the maximum rate of 28%. Under the House bill, the lower corporate rate for long-term capital gains would be eliminated. Long-term capital gains of corporations would be taxed at the same rate as ordinary income which, under the House bill, would be lowered from 46% to 36% (with lower rates for income not exceeding US$ 75,000). Thus, the House bill would mean a minimum 8 point increase in the FIRPTA tax on long-term capital gains.

In the case of individuals and other noncorporate taxpayers, the maximum rate on long-term capital gains would only increase from 20% to 22%. Under current law, noncorporate taxpayers are permitted to deduct 60% of their long-term capital gains and are taxed only on 40% of such gains. Noncorporate taxpayers are taxed on their income at a maximum 50% rate. Thus, the 60% deduction for long-term capital gains means that noncorporate taxpayers are taxed on such gains at a maximum 20% rate (50% maximum rate x 40% of gain). The House bill would retain the deduction for long-term capital gains, limited to 50% for taxable years beginning in 1986 and 42% for taxable years beginning after 1986. Those successive limitations are geared to the progressive reduction in income tax rates under the House bill. The House bill lowers the maximum income tax rates to 44%, effective in 1986, and to 38% effective in taxable years beginning after 1986. Thus, the capital gains deduction would produce a maximum rate of 22% (i.e. 50% of 44%) in 1986 and 22.04% (i.e. 58% of 38%) thereafter.

Corporate investors would not only be taxed at a higher rate on their long term capital gains, but might also be taxed on greater amounts of capital gains, comparatively speaking, as a result of the broadening of the tax base, as discussed below. Noncorporate investors would be similarly affected, although to a lesser extent because their long term capital gains would continue to be taxed at a lower rate.

B. Depreciation and tax credits (Secs. 201, 202, 203, 211, 223, 225, 232 of the House bill; I.R.C. Secs. 38, 46, 57, 168, 312(k), 1250 and new Sec. 49).

Depreciation

Under present law, most U.S. real estate (other than land) may be depreciated under the Accelerated Cost

3. "I.R.C." refers to the Internal Revenue Code of 1954, as amended.
4. Long-term capital gains are gains on the disposition of property held by the taxpayer for more than 6 months, if the property has been acquired after 22 June 1984 or before 1 January 1988. Other property is subject to a one-year holding period in order to qualify for long-term capital gains treatment on disposition.

Recovery System (ACRS) over 19 years using an accelerated 175%-declining-balance method[5] switching to a straight-line method at such time as to maximize the deduction. Preferential depreciation rules apply to low-income housing. The depreciation period was recently raised from 15 years to 19 years effective for real property placed in service after 8 May 1985. Generally, the use of an accelerated method of depreciation gives rise to a certain amount of depreciation recapture income, treated as ordinary income upon disposition of the real estate and, for this reason, the straight-line method is generally preferred by investors.

The House bill would replace ACRS with the Incentive Depreciation System (IDS) under which most depreciable assets would be grouped into ten classes according to present class lives (or "midpoint lives") under the Asset Depreciation Range (ADR) system, as in effect on 1 January 1985. Most U.S. real estate (other than low-income housing and certain other real estate such as telephone distribution plant) would belong in class 10. Properties in Class 10 are not entitled to accelerated depreciation and would be depreciable over a 30-year period using a straight-line method which would, in effect, cut the depreciation deduction by more than half compared to current depreciation rates. In addition, the use of the IDS 30-year depreciation rate may give rise to a 25% minimum tax (see below). To avoid the minimum tax, taxpayers would have the option to elect out of IDS in which case the real estate must be depreciated over a 40-year period using a straight-line method. A 40-year recovery period on a straight-line basis would also be used for purposes of computing corporate earnings and profits.

The bill also assigns longer depreciation periods for personal property, which would affect personal property associated with real estate (e.g. furnishings, equipment, elevators, etc. which are not considered structural components of the property). Low-income housing would continue to benefit from preferential treatment but to a lesser extent. Low income housing (other than "very low-income housing")[6] would be placed in class 9 and be recovered over a 30-year period at a 200% rate, switching to the straight-line method at the time which maximizes the deduction. Very low-income housing would be placed in Class 7 with a 20-year recovery period, using a 200% rate, switching to the straight-line method at the time which maximizes the deduction. The acceleration component in the recovery of low and very low-income housing may trigger the application of a minimum tax. To avoid the minimum tax, the taxpayer may elect to depreciate those properties on a straight-line basis over the same recovery period.

The drastic reduction in depreciation deductions may not necessarily be compensated for by the proposed lower income tax rates, especially for investments using substantial equity funding. For those investments, fairly typical among foreign investors, especially institutional investors, the reduction in depreciation deductions as proposed in the House bill would likely result in a greater amount of U.S. tax on real estate operating income than is incurred under present law. Although the House bill contains new provisions for inflation adjustments which might ameliorate the tax, its impact would be modest if not negligible in a low or moderate inflationary environment.

In an innovative move, the House bill would permit depreciation of assets, including real estate, beyond their original cost basis through limited adjustments for inflation under a formula, starting in 1988. In each year in which the Consumer Price Index (CPI) increase exceeds 5%, an inflation adjustment is calculated equal to the sum of (1) one, plus (2) 1/2 of the inflation rate in excess of 5%. (For instance, if the CPI increase for one year is 8%, the inflation adjustment for that year would be 1.015.) The depreciation deduction in any year is equal to the depreciation deduction (exclusive of any increase due to inflation adjustments) times the inflation adjustments for the taxable year and each prior taxable year during the taxpayer's holding period of the property. Additional deductions due to inflation adjustments do *not* reduce the basis of assets and do not give rise to recapture income on disposition. Thus, those adjustments are equivalent to exempting from tax an equivalent portion of the gain on disposition. However, those deductions are treated as an item of tax preference, possibly triggering the liability for the minimum tax (see below).

Investment tax credit

The House bill would generally repeal the existing 10% investment tax credit. This would affect real estate investors to the extent of real estate investments that include associated personal property (other than structural components of the building). The bill would retain only parts of the credit for rehabilitation expenditures. Under present law, the rehabilitation credit is 15% for nonresidential buildings at least 30 years old, 20% for nonresidential buildings at least 40 years old, and 25% for certified historic structures (residential and nonresidential). The House bill would lower the credit to 20% for the rehabilitation of historic buildings (residential and nonresidential) and to 10% for the rehabilitation of non-historic buldings which are nonresidential and were placed in service before 1936. Also, the bill would impose broader requirements for the conservation of the structure, including a requirement to retain at least 75% of the internal walls in addition to the present law requirement to retain at least 75% of the exterior walls.

C. Minimum tax (Sec. 53 of the House bill; I.R.C. Secs. 55-59)

The minimum tax has been in the law since 1970 and successive changes have increasingly broadened its scope. Under the House bill, the minimum tax takes

5. 175% declining balance method means depreciation at 1.75 times the normal straight-line depreciation rate.
6. Low and very low-income housing are defined as housing with a specified percentage of units occupied by individuals whose income is below a certain percentage of median gross income.

a significant leap forward and would be cast into a parallel tax system with broad potential application to corporations and high income-earning investors, including foreign investors. The minimum tax reveals and attempts to resolve the inherent conflict between the need to retain tax incentives in the law for tax policy or political reasons on the one hand and, on the other hand, the need to prevent those same tax incentives from being abused to the point of being counterproductive or of creating inequities in the overal tax system.

Under the House bill, the minimum tax rate would be raised to 25% for both corporate and noncorporate taxpayers (from 15% for corporations and from 20% for noncorporate taxpayers). The House bill would institute a unified set of alternative minimum tax provisions applicable to both corporate and noncorporate taxpayers, retaining certain differences. As proposed, the net minimum tax due would be the amount by which the tax computed under the minimum tax exceeds the taxpayer's regular tax, so that the taxpayer, in effect, pays the higher of the regular tax or the tax computed under the minimum tax provisions.

For the purposes of determining the minimum tax, a minimum taxable base is computed, starting with the regular taxable income increased by items of tax preference. Certain tax credits are not allowed as a deduction against the minimum tax.

For investors in real estate the significant items of tax preference would be as follows:

(1) the excess of any depreciation deduction over the deduction resulting from a straight-line 40-year recovery period;
(2) the additional depreciation deductions attributable to inflation adjustments in the calculation of the depreciation deduction;
(3) the net capital gain deductions granted to noncorporate taxpayers (subject to a special formula to ensure that long-term capital gains would not be taxed at a rate exceeding 22%).[7] Capital gains of corporations would no longer give rise to a tax preference item since they would be taxed at the same rate as ordinary income;
(4) excess passive activity losses of non-corporate taxpayers only.[8]

Further, rehabilitation credits could not be claimed as a credit against the minimum tax.

D. Extension of "at risk" rules to real estate activities (Sec. 401 of the House bill; I.R.C. Sec. 465)

Present law provides an at-risk limitation on losses from business and income-producing activities, other than real estate and certain other business activities of corporations, applicable to individuals and certain closely-held corporations. The rule is designed to prevent a taxpayer from offsetting losses from an activity against income from other sources to the extent those losses are in excess of the taxpayer's actual economic investment in the activity.

In the case of a foreign investor in U.S. real estate these new rules will probably be of limited impact because foreign investors do not ordinarily seek to take advantage of "tax sheltering" the way U.S. taxpayers do. One area of possible application would be where the foreign investor (an individual or a closely-held foreign corporation) holds a limited partner's interest in various real estate limited partnerships. Losses arising from a limited partnership with certain non-recourse financing might not be deductible against the taxable income arising from another limited partnership under the new at-risk rules because the rules would treat each such partnership investment as a separate activity.

E. Pledges of installment notes (Sec. 903 of the House bill; I.R.C. Sec. 453C)

Under present law, gain from the sale of property (including real estate) in exchange for which the seller receives deferred payments may be reported on the installment method, meaning that the tax on the gain will be due when and to the extent deferred payments are made. Generally, if an installment obligation is disposed of, gain is recognized to the extent of the value realized by the seller upon such disposition. In general, the mere pledge of an installment obligation as collateral for a loan is not treated as a disposition and does not trigger the tax. The House bill would remove the pledge exception and would treat as a taxable disposition the pledge of an installment obligation. An exception is provided where the potential deferral of gain does not exceed 9 months or where the installment obligations are pledged for indebtedness with a term not exceeding 90 days.

F. Repeal of certain tax-free liquidation rules (Sec. 331 of the House bill; I.R.C. Secs. 336, 337, 338, and 1362)

Individual foreign investors typically own U.S. real estate, directly or indirectly, through foreign corporations, often for U.S. estate tax reasons. Yet, on the disposition of his U.S. real estate, a foreign investor is often able to limit the U.S. tax on long-term capital gains to the individual rate rather than incur the corporate rate provided the foreign corporation is resident in a country which has concluded a tax treaty with the United States. Under present law, this represents an

7. It is assumed that a final version of the tax reform bill will make a conforming amendment to section 897(a)(2) imposing a 20% minimum tax on nonresident alien individuals taxed on gains from the disposition of U.S. real property.
8. New I.R.C. section 58 dealing with the denial of certain losses which would be added by section 501 of HR 3838 is not explicitly limited to non-corporate taxpayers and would seem on its face to apply to corporations as well. However, the Committee Report accompanying HR 3838 clearly limits the provisions to noncorporate taxpayers and House Ways and Means Committeee staffers have confirmed that this is the intent. Thus, it should be anticipated that a final version of H.R. 3838 would correct I.R.C. section 58 to reflect this intent.

8 point saving since the maximum rate on long-term capital gains is 20% for individuals and 28% for corporations.

The House bill would generally repeal certain tax-free liquidation rules which now make this saving possible so that real estate gains would become taxable at the 36% new maximum corporate rate and the 22% new maximum individual rate for long-term capital gains would not be available. An exception would remain for long-term capital gains realized upon the disposition of active real estate (other than vacant land or net-leased properties) held for at lest 5 years and allocable to at least 10% shareholders who have held their stock for a minimum 5-year period.

G. Branch tax
(Sec. 651 of the House bill; I.R.C. new Sec. 883)

(1) Present law: second-level withholding tax

Under present law, a foreign corporation which is engaged in a trade or business in the United States must generally withhold a 30% tax on its payments of dividends and certain interest to persons other than U.S. residents. This tax is often referred to as the "second-level withholding tax" on interest and dividends. A foreign corporation becomes liable to withhold only when more than 50% of its gross income is effectively connected with its U.S. trade or business over a 3-year testing period. In that case, the second-level withholding tax is applied on amounts of interest and dividend payments in proportion to the gross income of the foreign corporation that is effectively connected with its U.S. trade or business.

A liability for the second-level withholding tax, either on dividends or interest, is rarely incurred under present law principally because of the 50% threshold, the remittance rule (generally, the tax is due only upon actual payment) and U.S. tax treaties which often waive the tax entirely or in part.

(2) Proposed branch tax

The House bill would substitute a branch tax for the second-level withholding tax, the imposition of which would no longer depend upon the foreign corporation deriving a majority of its gross income from U.S. trade or business activities nor upon remittance of the dividends or interest income to shareholders or creditors. Further, the new provisions would override existing treaties in a number of ways. Particularly, some current treaty benefits would be limited by an anti-tax treaty shopping rule.

This proposed change appears totally unjustified, introducing additional complexity in the tax laws without clear benefit. According to the House Committee Report accompanying H.R. 3838, the change is designed to facilitate the collection of the second-level withholding tax and to better equalize the U.S. tax treatment of branches with that of subsidiaries by eliminating the arbitrary 50% threshold. This latter goal would hardly seem to be achieved, as, in fact, the tax treatment of a branch and a subsidiary would remain substantially dissimilar, with subsidiaries being in general somewhat better treated than branches. As regards disclosure, it would be possible to better enforce the second-level withholding tax through appropriate disclosure on annual income tax returns of foreign corporations. Further, its impact on revenue is minimal since it is estimated to yield only US$ 145 million in additional revenue over 5 years. Yet, its impact would be substantial on foreign-owned U.S. real estate, because of the way in which the FIRPTA rules operate. For no apparent policy reason, the branch tax would cause real estate investments to be subject to more burdensome U.S. taxation than that borne by other foreign-owned U.S. investments.

(a) *Branch tax on profits*

Absent a tax treaty, the branch tax would be imposed at a 30% rate on the repatriated earnings of a foreign corporation which are effectively connected with a U.S. trade or business. Thus, the tax would apply to any gains from the disposition of U.S. real estate by a foreign corporation including, presumably, gains from the disposition by a foreign corporation of an interest in a domestic U.S. real property holding corporation[9] or in a partnership or trust holding U.S. real estate.[10] Thus, if a Panamanian corporation sells a building it owns in the United States, the net gain would be subject to the FIRPTA tax at a 36% rate and the remaining net profit (reduced by the FIRPTA tax) would be subject to a 30% branch tax unless the corporation reinvested the proceeds into other U.S. real estate or other U.S. business activities. If the Panamanian corporation owns the stock of a U.S. corporation which owns the building and the Panamanian corporation sells the stock of the U.S. corporation, the branch tax would also probably apply, even though it can hardly be said that the Panamanian corporation has a branch in the United States. Under current rules, the gain realized upon the sale of the building or of the shares of stock of the U.S. corporation might be subject to the 30% second-level withholding tax, but only to the extent such gains were paid as a dividend (or as interest) and the tax might not apply if the corporation

9. Under I.R.C. section 897(c)(2), a U.S. real property holding corporation is defined as a corporation which has 50% or more of the fair market value of its business assets invested in U.S. real estate.

10. Under the House bill, the branch tax would be imposed on "any foreign corporation engaged in a trade or business within the United States during the taxable year" and the tax would be imposed on the "dividend equivalent amount", defined as the foreign corporation's effectively connected taxable income for the taxable year, as adjusted. Under I.R.C. section 897(a)(1) the gain or loss of a nonresident alien individual or foreign corporation from the disposition of U.S. real property interest (including an interest in a U.S. real property holding corporation) is taxed for purposes of Title 26 of the U.S. Code (the Internal Revenue Code), "*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". It is assumed that the branch tax is intended to apply to actual as well as "deemed trade or business situations, such as those created under section 897. Although the proposal is entitled "second level branch tax", the existence of a branch is not a prerequisite for the tax to apply and, in fact, the term "branch" is neither defined nor used in the provisions.

derived a majority of its gross income from non-U.S. business activities.

At this juncture, a policy question must be resolved, i.e. whether Congress intends to discourage foreign investments in U.S. real estate through a deliberate policy of taxing foreign-owned U.S. real estate more than other foreign-owned investments.

The taxable base for the branch tax on profits is the foreign corporation's taxable income effectively connected with a U.S. trade or business, (1) reduced by the income tax[11], (2) further reduced by earnings reinvested in the United States[12] by the foreign corporation, and (3) increased by previously reinvested earnings which are repatriated from the United States. The reductions and increases in the tax base would be calculated on the basis of variations in the net equity by comparing the adjusted bases of the branch's assets less its liabilities at the end of the year with the adjusted bases of the branch's assets less its liabilities at the beginning of the year. The taxable base would be increased by reduction in the net equity and decreased by increases in the net equity. Thus, a tax would be ultimately due upon subsequent disinvestments of reinvested earnings including, presumably, upon liquidation of the U.S. activities or of the foreign corporation. The allocation of the foreign corporations's assets and liabilities to its U.S. trade or business would be effected on the basis of principles consistent with those used in allocating interest deductions under I.R.C. section 882(c)(1). Those principles are contained in regulations, section 1.882-5, promulgated in 1980. Authority would be given to the Treasury Department to issue regulations necessary to carry out the purpose of the branch tax provisions, including to prevent abusive year-end manipulations to reduce the tax base.

It is assumed that the regulations will prescribe the necessary adjustments to bring the taxable base calculations closser to the concept of corporate earnings and profits. For instance, capital losses do not decrease effectively connected taxable income (to the extent it consists of ordinary income). In fact, capital losses would reduce net equity, thus triggering a branch tax, even though the net taxable income (without regard to the capital loss) is zero or is reinvested in the U.S. trade or business. In contrast, if an ordinary loss is incurred, it would reduce taxable income which should offset the corresponding decrease in net equity. Further, the bill assumes a perfect match between tax and accounting treatment. However, because differences exist, the branch tax base might be inadvertently increased or decreased, regardless of reinvestment or disinvestment of earnings by the U.S. "branch". For instance, tax exempt income (e.g. from municipal bonds) would not count toward effectively connected taxable income but would increase net equity. This would allow tax-exempt income to be remitted to the home office (or shareholders) without liability for the branch tax. In the case of a U.S. subsidiary, such income would increase earnings and profits and its payment as a dividend would trigger a U.S. withholding tax. Other examples of mismatch include depreciation deductions and capitalization and amortization of certain items (e.g. construction interest) which are treated differently for book and tax purposes.

In that regard, it is assumed that necessary adjustments will be made to book accounting to reflect the rules of I.R.C. Section 312 dealing with adjustments for computing earnings and profits.

Another problem in using a net equity concept to measure reinvestment and disinvestment of profits is liabilities. For instance, an increase in liabilities without a corresponding increase in assets would reduce net equity, triggering a branch tax, even though there are no corresponding earnings.

Further, it is hoped that the regulations would permit the necessary adjustments in the event of liquidation of the U.S. trade or business activities upon liquidation of the foreign corporation so that invested equity is not treated as a taxable amount upon its withdrawal, as it would seem to be the case under a literal reading of the bill provisions.

(b) *Branch tax on interest*

The branch tax would also be imposed at the 30% rate on certain interest paid or accrued by the foreign corporation. The branch tax on interest is largely equivalent to denying a deduction for certain interest expenses in determining the taxable base for the branch profits tax.

Taxable interest includes only *allocable interest* which requires the following two-step determination. First, allocable interest is that which is allowable as a deduction in computing taxable income. (Query whether and to what extent capitalized interest, such as construction interest, is "allowable as a deduction".) Thus, this is the amount of interest determined from the application of the allocation regulations under Treas. Reg. § 1.882-5. Those regulations assume that money is fungible and foreign corporations which have had to make calculations under those regulations know that the amount of deductible interest expenses does not necessarily correspond to the amount of interest expenses charged to the U.S. activities on the books. In this regard it is believed that interest charged by the home office on advances made to its U.S. operations would not be taxable interest to the extent is is not an allocable interest expense under Treas. Reg. § 1.882-5.

Second, allocable interest subject to the branch tax is limited to that which "would be subject to the with-

11. Like domestic corporations, foreign corporations are subject to the minimum tax, However, it is unclear whether such minimum tax would be deductible from the tax base. Also, a foreign corporation may be subject to the accumulated earnings tax under I.R.C. section 531 or a foreign personal holding company tax under I.R.C. section 551 (or the personal holding company tax under I.R.C. section 541). It is not clear that those supplemental taxes would be deductible from the tax base. In contrast, it is noted that a subsidiary would be allowed a deduction for all those taxes in computing the amount of its earnings and profits available for a taxable dividend distribution.

12. The bill provisions would apparently not require the earnings to be reinvested in the same business. The reinvestment could be made in any U.S. trade or business of the foreign corporation.

holding tax under section 1441 or 1442 if the foreign corporation were a domestic corporation". This approach requires the amount of allocable interest determined under the first step to be traced to various liabilities of the foreign corporation. Unless the regulations provide tracing rules, an apportionment of the allocable interest would have to be made among those various liabilities to determine whether a withholding tax would be imposed, were the interest paid by a domestic corporation.

The reference to I.R.C. sections 1441 and 1442 would exclude from the branch tax interest allocable to the following liabilities: liabilities to U.S. lenders; obligations with maturity not exceeding 6 months bearing original issue discount; and liabilities generating "portfolio interest" as defined in I.R.C. sections 871(h) and 881(c). Under the statute, "portfolio interest" includes most interest with notable exceptions, such as interest on loans from banks or other financial institutions made pursuant to a loan agreement and interest on loans from 10% or more affiliated persons (shareholders or affiliated corporations, based upon the ownership attribution rules of I.R.C. section 318, as adjusted).

Under Treasury regulations issued on 17 August 1984, the term "portfolio interest" is narrowly defined and is, in fact, limited to interest on "registration-required obligations", as defined in I.R.C. section 163(f)(2). Thus, following the definition of a registration-required obligation, interest potentially subject to the branch tax would also include interest on any obligation which is not of a type offered to the public (e.g. private placements),[13] or has a maturity of not more than 1 year.[14]

As a result of the method prescribed in the bill for determining the amount of allocable interest, a foreign corporation might not easily control or plan the branch tax on interest. For instance, it could decide that all its U.S. operations will be financed either from equity or from loans from U.S. banks. This would not necessarily avoid a branch tax interest if it borrows from other sources outside the United States to finance its non-U.S. operations, For instance, a foreign corporation, not a resident in a treaty country, might own U.S. real estate and also have borrowed in Japan to finance operations there. It is possible under Treas. Reg. § 1.882-5 that an amount of interest expenses allocated to the U.S. activities would be allocable to the Japanese loan. If so, what rate would apply? Possible answers are 30%, 10% or zero.

(i) The 30% theory would be based upon the fact that the interest allocable to the Japanese borrowing is "subject to withholding tax" since it would be subject to a 10% withholding tax if it were paid by a U.S. corporation to a Japanese lender under Article 13(4) of the U.S.-Japan tax treaty. Therefore, the interest must bear the branch tax at the 30% rate since the foreign corporation is not protected by a treaty.

(ii) The 10% theory would be based upon a less literal reading of the House bill provisions but would be closer to the overall intent of the provisions. Indeed, the interest is subject to tax because it is deemed paid by a U.S. corporation to a Japanese lender. Thus, the provisions of the U.S.-Japan tax treaty should apply to reduce the 30% rate to 10% and this would better parallel the tax treatment of a U.S. branch to that of a U.S. subsidiary.

(iii) The zero rate theory would be based upon Article 4(1) of the U.S.-Japan tax treaty which provides that a resident of Japan may be taxed only on income from sources within the United States. It could be argued that, under Article 6(2)(a) of the treaty, the interest is not sourced in the United States,[15] and, therefore, cannot be taxed by the United States.

The main difficulty with both the 10% and the zero rates theory is that the branch tax, under the House bill provisions, is imposed on the foreign corporation and not on the foreign lender and, thus, the treaty does not apply, if read literally. This difficulty would be solved if the branch tax provisions recognized the "derivative" application of tax treaties, meaning that, as to interest, the provisions of the tax treaty between the United States and the country of residence of the lender should apply, subject to all the limitations in that treaty.

The derivative approach seems to be the correct approach as it would eliminate certain arbitrary results. For instance, if the lender were a U.K. bank, the interest allocable to the U.K. bank loan would probably not be subject to a branch tax. This is because the withholding tax on interest is eliminated under Article 11(1) of the U.S.-U.K. tax treaty and, therefore, it is assumed that this would not be interest "subject to withholding tax under section 1441 and 1442". It is difficult to rationalize an exemption in the case of a U.K. loan and a 30% branch tax in the case of a Japanese loan, simply because in the first case, the U.K. treaty reduces the rate to zero and, in the second case, the Japanese treaty reduces the rate only to 10%.

Another difficulty with the branch tax on interest is the fact that the tax is imposed on the foreign corporation and not on the foreign lender. Thus, the branch tax is a net increase on the tax and economic burden borne by the foreign corporation. In contrast, a U.S. subsidiary would pay interest to a foreign lender, net of the U.S. withholding tax. While interest rates may

13. The regulations under I.R.C. section 163(f)(2) provide some examples of an obligation "not of a type offered to the public".

14. A registration-required obligation also does not include an obligation issued by a natural person but this rule would not affect the branch tax which could apply only to interest on obligations issued by corporations. The regulations are inconsistent with the letter of section 127 of the Deficit Reduction Act of 1984, which repealed the U.S. withholding tax on portfolio interest, effective 19 July 1984. There is no clear legislative history supporting the Treasury interpretation. There is some chance that legislation will be passed to restrict the scope of portfolio interest to that on registration-required obligations but it is unlikely that such legislation would have retroactive effect.

15. For instance, because the foreign corporation does not have a U.S. permanent establishment or because principles different from those in Treas. Reg. § 1.882-5 apply for determining source under the treaty. This is a complex issue, beyond the scope of this article.

be adjusted to reflect this distortion, adjustments would rarely be complete, if only because it would not be possible to know at the time of borrowing by the foreign corporation how much of the interest on a particular loan would be "allocable interest" under the rules of Treas. Reg. § 1.882-5. While the foreign corporation may get double taxation relief in its home country, relief may not be meaningful if the home country applies an exemption system or may be incomplete if the home country applies a foreign tax credit system and the foreign corporation has excess foreign tax credit or the branch tax does not qualify as a creditable tax.

(c) *Override of tax treaties in the case of "treaty shopping"*

The bill provides that, subject to certain exceptions, the branch tax would not apply to foreign corporations resident in a country which has a tax treaty with the United States, if that treaty prevents the imposition of such a branch tax (presumably on the basis of the non-discrimination provisions of a type normally included in U.S. tax treaties). Most tax treaties would prevent the imposition of a branch tax on profits, with a few notable exceptions, such as the tax treaties with Australia, Canada and France. Thus, a corporation in Canada, France or Australia owning U.S. real estate would bear a branch tax on its profits, but at a lower rate of 10% in the case of Canada and France and 15% in the case of Australia.[16] It is unclear whether the branch tax could apply to interest under those treaties. In fact, with the exception of the tax treaties with Poland, Romania, South Africa, and Soviet Union, it seems that all U.S. tax treaties currently in force would prevent the imposition of a branch tax on interest based upon the non-discrimination provisions in those treaties.[17]

With respect to tax treaties that prevent the imposition of a branch tax, the bill distinguishes between two categories:

(1) tax treaties which prevent the imposition of a branch tax but permit the imposition of a second-level withholding tax: the branch tax on profits or interest, or both, would not apply to a corporation resident in one of those treaty countries and the provisions of current law would continue in effect subject to the modifications of current law in the applicable treaty;[18]
(2) tax treaties which prevent both the imposition of a branch tax and of the second-level withholding tax: those treaties are overriden by the branch tax provisions under the anti-tax treaty shopping rule. In essence, under this rule, a foreign corporation claiming to be exempt both from the second-level withholding tax *and* from the branch tax under a tax treaty would be so exempt only if its stock were at least 50% beneficially owned by residents in the treaty country or if its stock were primarily and regularly traded on an established securities market in *that* country. Treaties in this category are mainly older U.S. tax treaties such as those with the Netherlands Antilles, the Netherlands, Germany, Luxembourg, and to a certain extent, Switzerland.

Of all foreign investments in the United States, real estate would probably be the most adversely affected by this anti-treaty shopping rule, principally because those investments are largely owned by Netherlands Antilles corporations which are owned by non-residents of the Netherlands Antilles.[19] The U.S.-N.A. tax treaty and favorable Netherlands Antilles domestic tax rules have traditionally contributed to make the Netherlands Antilles an attractive base jurisdiction for U.S. real estate investments both by residents of non-tax treaty countries and by residents of tax treaty countries whose preference is to own their U.S. real estate outside their country of residence. After FIRPTA was enacted, the Netherlands Antilles continued to attract foreign investors in U.S. real estate principally because Article XII of the U.S.-N.A. tax treaty waives the second-level withholding tax on dividends and interest. Under the bill, this protective treaty provision could no longer apply to relieve those N.A. corporations from the 30% branch tax since they normally have no local ownership. *Consequently, foreign-owned N.A. corporations disposing of their U.S. real estate would have to incur the 36% FIRPTA tax plus a 30% branch tax, that is a total combined tax liability of approximately 55%.* Many investments would also have to restructure their financing, since loans from shareholders would be subject to the branch tax on interest. Financing would have to be raised from U.S. persons or from unrelated third parties which are not banks or financial institutions.

The election under IRS section 987(i) may provide some relief to a Netherlands Antilles corporation from the branch tax on profits . For instance, a Netherlands Antilles corporation having made an election under I.R.C. section 897(i) might sell all of its assets (for

16. It is assumed that H.R. 3838 does not intend to override existing treaty provisions which limit the branch tax rate and provide other relief with respect to the branch tax.
17. At an earlier stage of the tax reform process, some U.S. Treasury officials were of the view that the non-discrimination provision in some older U.S. tax treaties (e.g. those with Switzerland, Germany and the Netherlands Antilles) were inadequate to prevent the imposition of a branch tax. This undercertainty has not been cleared in the House bill. In fact, the House Committee report states that "a branch-level tax does not unfairly discriminate against foreign corporations because it treats foreign corporations and their shareholders together not worse than U.S. corporations and their shareholders. Therefore, the committee believes that permitting the branch tax to override conflicting treaties is not improper, since any discrimination involved is more technical than substantive". This statement is probably meant to support the committee's decision to override tax treaties in treaty-shopping situations. However, it does nothing to clear the earlier uncertainty and opens the door to a general override of all tax treaties.
18. Most tax treaties which permit the imposition of a second-level withholding tax contain certain relief measures in the form of lower rates and/or higher thresholds for imposition of the tax. It is assumed that the new branch tax provisions would not override those treaty reliefs.
19. U.S. Commerce Department Statistics for 1984 show that about 21% of total foreign-owned U.S. real estate is held by Netherlands Antilles corporations. This makes the Netherlands Antilles the second largest investor in U.S. real estate after the United Kingdom which accounts for about 25%. Source: Bureau of Economic Analysis, Department of Commerce, 1985.

notes or cash, or both) in a tax-free liquidation-sale under I.R.C. section 337. The non-corporate shareholder would be subject to the FIRPTA tax upon subsequent liquidation of the Netherlands Antilles corporation but would not bear the branch tax since it only applies to corporations. This possibility, however, would be of very limited application if the House bill provisions repealing the tax-free liquidation rules (I.R.C. sections 336 and 337) are enacted.

On the other hand, U.S. real estate beneficially owned by residents of treaty countries such as, for instance, U.K. or Dutch individuals or pension funds owning U.S. real estate directly or through a U.S. corporation would be exempt from the branch tax by virtue of the non-discrimination provisions of the U.S.-U.K. or U.S.-Netherlands tax treaty and the special treaty override would not apply in their case because there would be no "treaty shopping"[20]

The branch-level tax is intended to apply to all profits realized after 1985 which gives it a retroactive effect since it would tax all pre-1986 built-in appreciation of any U.S. real estate which is disposed of after 1985.

IV. EFFECTIVE DATES

The provisions in the House bill that most concern foreign investors in U.S. real estate would generally be effective in 1986 or earlier:

Reduction in maximum corporate tax rates from 46% to 36%	Taxable years beginning on or after 1 July 1986
Increase in corporate long-term capital gain rate from 28% to 36%	Gains recognized after 1985 excluding post-1985 gains attributable to a sale or exchange on or before 25 September 1985 or pursuant to a binding contract in effect on or before 25 September 1985. This transition rule would protect gains recognized after 1985 on installment sales within the transition rule.
Changes in depreciation and tax credits	Property placed in service after 1985 (within limits) for property acquired, constructed or reconstructed pursuant to a written contract that was binding as of 25 September 1985.
Minimum tax	Taxable years beginning after 31 December 1985
"At-risk" rules	Losses attributable to property acquired after 31 December 1985.
Pledge of installment sale obligations	Pledges of obligations after 31 December 1985, and pledges of obligations arising after 25 September 1985 that were pledged before 1 January 1986, if still outstanding in 1986. Transition rules apply to obligations pledged in 1986 or in 1987.
Repeal of certain tax-free liquidation provisions	Distributions or sales and exchanges effected on or after 20 November 1985 pursuant to a plan of liquidation adopted on or after 20 November 1985.
Branch-level tax	Taxable years beginning after 31 December 1985.

In response to protests that 1986 effective dates create too much uncertainty in planning business transactions, both the House and the Senate adopted non-binding resolutions in December 1985 which suggest that effective dates might generally be postponed until 1 January 1987. However, attempts to provide a more certain commitment have failed and there is a risk in relying on changes in the effective dates.

V. POSSIBLE LEGISLATIVE EFFORTS

In recent years several bills have been introduced in the U.S. Congress to repeal the FIRPTA provisions, and particularly S. 1915, introduced by Sen. Goldwater on 3 October 1983 (reintroduced by him as S. 195 on 21 January 1985) which has a number of supporters among senior-ranking members of the House and the Senate. The Senate Finance Committee held hearings on the Goldwater bill on 19 June 1984 but no action has followed.

The introduction of repeal bills in 1985 indicates continued interest in the area but supporters in the House appear to have gained no significant support among members of the House Ways & Means Committee or on the House floor to include FIRPTA repeal provisions in H.R. 3838. Outcome on the issue in the Senate and, later, in the conference (where differences between the House and the Senate versions of the tax bill would be reconciled) is uncertain at this point although support for a FIRPTA repeal would seem more vigorous in the Senate Finance Committee than it ever was in the House Ways and Means Committee.

Apart from efforts to repeal FIRPTA, it is anticipated that there will also be efforts to prevent the enactment of a branch tax on the theory that foreigners should be taxed only once on their U.S. real estate investments.

20. There is a troublesome gap in the non-discrimination provisions of many tax treaties and this may cause an accidental loss of protection against the branch tax in the case of U.S. real estate capital gains. There is no provision in the non-discrimination article or other articles of the U.S.-U.K. tax treaty which would prevent the United States from imposing a discriminatory tax on the U.S. effectively connected capital gain of a U.K. corporation, if such gain is not attributable to a U.S. permanent establishment. This problem would seem to exist with respect to tax treaties which include a specific permanent establishment provision in their nondiscrimination article and which do not prevent the United States from taxing capital gains. Besides the U.K., this would appear to concern a number of tax treaties including those with Belgium, the Netherlands, Cyprus, Denmark and Italy.

VI. CONCLUSION

The changes proposed in the H.R. 3838 affect the U.S. taxation of real estate investment by foreigners in many ways. The most significant effects may be summarized as follows:

A. U.S. real estate investment owned by a foreign corporation (or other entity taxed as a corporation in the U.S.)

(1) *Operating income*

- Broadening of the tax base resulting principally from longer depreciation periods and lower tax credits, possibly offsetting the benefits from a reduction of the maximum corporate tax rate from 46% to 36% or even resulting in a larger tax liability (or smaller net operating losses) than under current rules.
- 30% branch tax applying to repatriated operating income, except for investments beneficially owned by residents in a country whose tax treaty with the United States prevents the branch tax.
- 30% branch tax on certain interest paid or accrued to non-U.S. persons, essentially on shareholders' loans and on loans from banks or financial institutions, except for investments beneficially owned by residents in a country whose tax treaty with the United States prevents the branch tax.[21]
- Minimum tax preventing certain accelerated depreciation deductions and credits from reducing the tax liability below an effective 25% rate.

(2) *Gains on disposition*

- Taxed at the maximum corporate rate of 36% rather than the current maximum 28% rate in the case of long-term capital gains.
- Subject to the 30% branch tax if not reinvested in the U.S. except for investments beneficially owned by residents in a country whose tax treaty with the United States prevents the branch tax. The branch tax would also apply to the gain on the disposition of shares of stock in a U.S. real property holding corporation or of an interest in a U.S. real property partnership.
- Continue to be subject to the 10% FIRPTA withholding tax.

(3) No U.S. estate tax upon death of a foreign shareholder.

B. U.S. real estate investment owned by foreign individuals directly or through a U.S. or foreign partnership or trust:

(1) *Operating income*
- Broadening of the tax base resulting from longer depreciation periods and lesser tax credits possibly offsetting the benefits from a reduction of the maximum individual tax rate from 50% to 38% or even resulting in a larger tax liability (or smaller net operating losses) than under current rules.
- No branch tax.
- Minimum tax preventing certain accelerated depreciation deductions and credits from reducing the tax liability below an effective 25% rate.

(2) *Gains on disposition*
- Taxed at a maximum 22% rate rather than the current 20% rate in the case of long-term capital gains.
- No branch tax.
- Minimum tax preventing preferential treatment of long-term capital gains from reducing the tax liability below an effective 20% rate.

(3) U.S. estate tax applies upon the death of the foreign individual investor.

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21. The branch tax would apply regardless of whether the foreign corporation has elected to be treated as a U.S. corporation under I.R.C. section 897(i). However, an electing corporation may be able to dispose of its assets in a tax free sale and avoid the branch tax provided it is owned by a noncorporation shareholder and it liquidates after the sale. This possibility, however, may be of limited use if certain other provisions of H.R. 3838 are enacted.

In next issues:

Basic structure of the foreign tax credit system of Japan – by *Hiroshi Kaneko*

The Argentine income tax reform – by *Pedro Massone*

The OECD on personal income tax

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People's Republic of China: New regulations on foreign exchange balancing in joint ventures – by *Charles D. Toy*

Hong Kong: The UMELCO Report

Ghana: Tax incentives for investment, Ghana's more realistic approach – by *Servaas van Thiel*

Thailand: Highlights of changes in the tax laws – by *Montri Hongskrailers*

The Israeli Experience of an Inflation Adjusted Tax Base

With Special Reference to Income Tax Law (Adjustment for Inflation) Provisional Measure, 5755-1985

By Arye Lapidoth

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On 6 August 1985 a new law was published in Israel prescribing the adjustments which should be made in the taxable income because of the inflation: Income Tax Law (Adjustments for Inflation) Provisional Measure, 5755-1985[1] (hereinafter also referred to as "the new law"). As denoted by its name, the new law is intended to serve as a temporary measure only. It applies to the tax year 1985, i.e. the year beginning on 1 April 1985 and ending on 31 March 1986.[2] There are, however, rumors that it will be extended for an additional tax year (i.e. tax year 1986) ending on 31 March 1987.

The new law replaces the Income Tax Law (Taxation under Inflationary Conditions), 5752-1982,[3] which had been in effect for three years, and eventually expired on 31 March 1985 (i.e. at the end of tax-year 1984), hereinafter also referred to as "the old law" or "the 1982 law".

Two main problems confronted the legislature in both the old and the new laws. Firstly, how to protect the capital from erosion resulting from the taxation of the nominal profits, which amounted to the taxation not of the real profits, but of the capital itself. In the hyperinflation prevailing in Israel, the nominal profit consisted mainly of inflationary profit; hence its taxation, without proper adjustments for the inflation, would in effect result in a particularly grave erosion of capital.

The second problem facing the legislature was how to stop a most popular tax avoidance scheme practiced by Israeli taxpayers, i.e. the deduction of the high interest (as well as linkage differentials) payable for financing their business activities, thus unduly decreasing their taxable income.

BEFORE 1982

In order to fully understand those problems one should bear in mind that there was no comprehensive law for adjustment for inflation in Israel before 1982 (i.e. before the 1982 law came into force). Ever since its introduction in 1941, the Income Tax Ordinance has been based on the nominal value of currency. Certain specific pieces of legislation were enacted from time to time to solve problems arising from the growing inflation. The legislation, however, assumed the nature of patch work, thus leaving many areas not properly covered. For example: in certain cases the nominal profits derived from inflation (by a non-dealer) were exempted from tax altogether (e.g. Government bonds and securities quoted on the Tel Aviv stock exchange); in other cases the tax on such profits was limited (e.g. capital gains tax on inflation profits was limited to 10%). Other examples include special reliefs for inventory and various types of depreciation allowances.

On the other hand, the right to deduct interest payable on loans was also limited by a complicated legislation. However, the sporadic specific legislation has proved to be inadequate, giving rise to considerable distortions either in favor of the taxpayer or in favor of the Treasury. Most businessmen refrained from investing their own capital in their business. They preferred to borrow money and claim the financing expenses as a deductible business expense. Such deductions were fairly generously allowed, even though the taxpayers used the money so borrowed to purchase assets which were "protected", in full or in part, from inflation (e.g. securities quoted on the Tel Aviv stock exchange, real property or fixed assets).

On the other hand, there were businesses which had to virtually close down because of capital erosion resulting from the use of their own capital for buying assets which were not adequately "protected" by specific legislation (e.g. inventory not enjoying the specific reliefs). Consequently, depending upon the circumstances, the practice of claiming the deduction of the costs of financing business activities could either assume a genuine effort by the taxpayer to prevent his capital erosion, or as a means to avoid tax.

The same applies to other practices which have become popular, e.g. the planning of the right timing for receiving income or incurring an expense. Apparently, more taxpayers used the loopholes to avoid tax rather than to protect their capital from erosion, because the

1. *Sefer Ha-Chukkim* No. 1154 of 6 August 1985, at 172.
2. Unfortunately, retrospective legislation in the tax area has recently become a common feature of the Israeli law.
3. *Seker Ha-Chukkim* No. 1061 of 26 August 1982, at 234.

total yield of tax due from the "self-employed" sector, compared with the "employees", has diminished considerably.

THE 1982 LAW

The Income Tax Law (Taxation under Inflationary Conditions), which was introduced in 1982, was the first attempt ever made by the Israeli legislature to make all the necessary adjustments to inflation by comprehensive systematic legislation, thus altogether neutralizing the measurement of the taxable income from the element of inflation. It has also been the most controversial tax legislation. (Extensive legislation also took care of the *collection* of tax).

The 1982 law was analyzed by the late Dr. J.F. Pick in an article published in the Bulletin 1983 under the heading: "Introduction of an Inflation-adjusted Tax Base in Israel".[4] There is no need to repeat the details here. In order to understand the problems leading to the new law and to try and reach some conclusions, it may, however, be useful to recapitulate briefly the main features of the 1982 law.

In order to submit a tax return under the 1982 law, three phases were needed. Firstly, the balance sheet had to be prepared in accordance with the generally accepted principles of accounting. The second step was to adjust the balance sheet for the purpose of the regular income tax return. Here the accountant had to make the necessary adjustments wherever a specific provision of the Income Tax Ordinance, or related tax laws, deviated from the accepted principles of accounting (e.g. certain expenses are specifically disallowed by legislation though deductible under the accounting principles).

The third step was to make the adjustments under the 1982 law whenever the law applied. The basis for the adjustments was a comparison between the balance sheets at the beginning and the end of the tax year in order to follow the situation of the actual capital which was invested in the business. Generally, only taxpayers who kept books of account in accordance with the double entry system qualified for the law.

The basic structure of the law was as follows: Given that capital equals assets, one should adjust the assets to the inflation having regard to two types of assets, i.e. "protected assets" and "unprotected assets". On the other hand, the capital should also be adjusted, having regard to two types of capital, i.e. the taxpayer's own investment ("self-capital") and foreign capital (such as loans).

The "protected assets" were carefully defined by the draftsman in a schedule attached to the law (Schedule 2); the method of calculating the "self-capital" was meticulously prescribed by a set of elaborate rules laid down in Schedule 1. The law further included rules for adjustment (by means of a weighted – average principle) in respect of changes occurring, during the year, in the flow of capital, as well as transactions of "protected assets". The adjustments were calculated by reference to the consumer's cost of living index.

As long as the "self-capital" was directed to the acquisition of "protected assets" there was no need for any adjustment. Similarly no adjustment was needed where the acquisition of "unprotected assets" was financed by "foreign capital" (e.g. loans). However, where on the whole there was a surplus amount of "self-capital" which was used for acquiring "unprotected assets", the result was a "deficiency of the self-capital", which entitled the taxpayer to a special allowance. Where, on the other hand, more "foreign capital" was used for acquiring "protected assets", the result was "an accretion to self-capital"; the amount of such "accretion to capital" was added to the taxpayer's taxable income.

The law further included provisions in respect of notional (or imputed) income derived from loans at a low rate of interest as well as notional income derived from the appreciation in value of securities quoted on the stock exchange. The last measure eventually acted as a boomerang, when the Tel Aviv stock exchange collapsed, and taxpayers hurried to claim losses. Subsequently, a special anti-avoidance law was enacted, with a retroactive effect, to counteract tax avoidance schemes carried out by transactions not at arm's length in shares.

The most elaborate and complicated drafting of the law created many opportunities of tax planning for the sophisticated taxpayers. By the less sophisticated taxpayers the law was regarded as a nuisance, which could cause great harm, if the taxpayer is not careful enough to avoid the traps; e.g. if he withdrew a certain amount of money from his business at the wrong time he might later realize that by doing that he "acquired" an "accretion to capital" and consequently increased his tax liability.

In any case the layman who could not understand the law felt disrespect for it, as well as found perfect legitimacy to practice tax avoidance or even tax evasion.

Since the 1982 law was published, in August 1982 (with a retrospective effect as of 1 April 1982), it was amended four times within less than two years. Three of the amendments included numerous significant provisions effective, retrospectively, as of 1 April 1982. And yet the law has remained in a poor shape that required many more amendments to stop both the loopholes and the traps which have been left.

In December 1984, towards the end of three years of experiencing the 1982 law, interim recommendations were published by a public commission, which had been appointed by the Ministry of Finance to inquire into direct taxation under conditions of inflation.

The first question facing the commission was whether to extend the 1982 law for an additional period, subject to the necessary amendments. It recommended not to do so. In reaching that conclusion the commission

4. Pick, "Introduction of an Inflation-Adjustment Tax Base in Israel", 37 *Bulletin for International Fiscal Documentation* 6 at 259.

effectively accepted the recommendation presented by the Commissioner of Income Tax, who, in his appearance before the committee, summed up the experience of implementing the 1982 law as follows (a free translation from the Hebrew version):

a. "The law is too complex and cannot be properly implemented; it draws too much outstanding professional manpower needed for other missions of the department.
b. The law causes an unjustifiable loss of tax revenue".[5]

The commission was of the opinion that the proper system for determining the taxable income in the business sector under continuous conditions of inflation should be a system of linking the income, the expenses, the tax and the payment of tax, to a stable unit of measurement, such as the cost of living index, the dollar, or a similar unit of measurement, enabling a proper recording on a daily basis.

It has recommended the introduction of that system for the tax year 1986, by an entirely new legislation. Until the new legislation is completed, the 1982 law should be replaced by the new law, which was enacted, as a provisional measure, for the tax year 1985.

THE NEW LAW

Basically, the new law follows the same idea as the 1982 law. A taxpayer, who invested his own capital in assets which are not classified as assets protected from inflation, will get a special inflation allowance in order to preserve his capital. On the other hand, in so far as the acquisition of the taxpayer's protected assets was financed not by his own capital, but by a loan, his taxable income will be increased.

The adjustments to inflation are achieved by the new law in a method similar to the one adopted by the 1982 law. The basis of the formula is the initial "capital" at the beginning of the tax year as stated in the balance sheet ("self-capital" under the 1982 law). A set of elaborate rules determines whether, during the tax year, the capital underwent "positive changes" ("accretion to self-capital" under the 1982 law), i.e. the actual amount of real investment exceeded financing investment. The amount of "positive changes" is added to the initial "capital". Another set of rules determines whether the initial "capital" underwent "negative changes" during the tax year ("deficiency of capital" under the 1982 law), i.e. the taxpayer used more borrowed money than real investment. The amount of "negative changes" is subtracted from the "capital".

The next step is to establish the value of "fixed assets" ("protected assets" under the 1982 law), following the sale and purchase of "fixed assets" during the year. In so far as the value of the "fixed assets" at the end of the year exceeds their value at the beginning of the year, this is a negative element (because more of the capital is "protected" from inflation in the form of "fixed capital"). The increased amount should be subtracted from the "capital". If, on the other hand, the value of the "fixed assets" decreased, the change assumes a positive element and the decreased amount should be added to the "capital". Finally, the result would either be that the "capital" has increased, "a positive sum total of capital" ("deficiency of capital" in the 1982 law), or the capital has diminished, "a negative sum total of capital" (an "accretion to capital" in the 1982 law).

A "positive sum total of capital" represents a surplus of capital over fixed assets. Therefore, it entitles the taxpayer to a special "allowance because of inflation" (hereinafter also referred to as "inflation allowance"), which will naturally reduce his taxable income.

A "negative sum total of capital" represents a surplus of "fixed assets" over capital. It shows that the acquisition of some of the "fixed assets" (which are protected from inflation) has been financed by foreign loans. Hence, it is regarded by the law as an "addition because of inflation" (hereinafter also referred to as "inflation addition"). The amount of "inflation addition" is added to the taxpayer's taxable income.

Unlike the 1982 law, which, subject to certain limitations, entitled the taxpayer to a deduction representing the full size in the consumer's cost of living index, the "inflation allowance" in the new law is limited to 90% of the rise in the cost of living index. Consequently, the taxpayer is not compensated for the inflation in full. It should be noted that the method of calculation has also been changed, as well as adjustments in respect of the right to carry forward the right to set off losses. The change is apparently more favorable to the taxpayer. The amount of "inflation addition", which is *added* to the taxpayer's taxable income, is calculated on the basis of the *full* rise in the cost of living index, i.e. the full rate of inflation.

Other features of the new law which are worth mentioning are the following. The definition of "fixed assets" has been extended to cover equipment and machinery. Those items were not included in the old definition of "protected assets". Apparently, the old favourable attitude of law was motivated by the wish to encourage industry. The generosity resulted in a considerable loss of revenue and, hence, was abolished. Profits derived from securities quoted on the stock exchange will be charged to tax under a set of rules which have a harsher effect on taxpayers. The provisions relating to the valuation of inventory under the 1982 law were very lenient. By proper planning of the timing for purchasing the inventory the taxpayer could increase his "self-capital" and save a considerable amount of tax. A new set of elaborate rules for appraising inventory were introduced to stop the gap.

FOREIGN INVESTORS

There are certain types of taxpayers to which the new law does not apply. Worthy of particular mention are foreign investors (as specifically defined by the law).

5. Interim report of the public commission for inquiring into the direct taxation under conditions of inflation, presented to the Minister of Finance in December 1984, at 6.

Foreign investors, who are entitled to tax benefits under the Law for the Encouragement of Investments, may opt for the benefits under that law; the complicated inflation law will then not apply. Other categories of taxpayers to whom the law does not apply include, *inter alia*, diamond dealers who keep their books of account in foreign currency, and certain other types of taxpayers who do not claim a deduction for financing expenses. The latter may, at their option, notify the Treasury that they elect to be taxed under the new law.

SIMPLIFICATION

As has been shown, there are no major changes in the new law. The basic principles of the old law have remained. The changes have assumed the nature of a legislation aimed at stopping loopholes.

Before attempting to reach some conclusions a few words should be said about the drafting technique which has been used in the new law. It reflects the efforts which have been made to simplify the oversophisticated provisions of the 1982 law.

The new law is supposed to have been drafted in clearer language. Indeed, there are less cumbersome definitions and the terms used appear to be more intelligible to the reader. However, that goal appears to have been reached by resorting to more undefined general phrases or by using terms which appear in the Income Tax Ordinance, referring the reader to the meaning that should be given to them under that law. It is doubtful whether such a drafting technique will make the interpretation of the new statutory provisions any easier.

The most striking example is the introduction for the first time of the concept "principles of accounting", a term which has been defined in S.1 of the law as, "principles of accounting which were the accepted principles in Israel on 31 December 1984". It is not clear how the Courts of Law will establish what were the accepted principles of accounting in Israel on 31 December 1984. There may be considerable conflict concerning this point.

Another example is the more frequent use of accounting terms. The meaning of such terms is not always free from doubt, especially where they are used in the legal sense. Hence there might be a difference of opinion as to what was the intention of the legislature. It is most doubtful whether the new law would prove to be less complicated than the old one.

CONCLUSIONS

The Israeli experience of taxing income under conditions of continuous high rate inflation, it is submitted, has shown that even the most sophisticated legislation cannot adequately solve the problems involved in the measurement of the amount of taxable income and collecting the amount of tax due in reasonably real terms. Though not universally acknowledged, it may be safely stated that in implementing the Income Tax Law (Taxation under Inflationary Conditions), 5782-1982, for the last three years, only limited success has been achieved in wiping out the grave distortions created by the inflation. The replacement of the 1982 law by the provisional measure for 1985 will most probably prove also to be a disappointment.

In order to work properly, a comprehensive statute for adjustment of the taxable income for inflation should include elaborate provisions and definitions, using many technical terms, and phrased in a most intricate language. Perhaps paradoxically such a statute cannot be perfect unless it is oversophisticated. The great efforts which were made to stop all possible loopholes in the 1982 law, have resulted in a complex law. Now the complexity of the law has proven to be its weakest point. Again it has been demonstrated that the more complex and complicated a tax statute becomes, the more loopholes there are likely to be left.

Furthermore, although the Revenue issued a remarkably well written loose-leaf volume explaining the new law, and although numerous lectures and seminars were held, the common taxpayer could not understand the highly technical structure of the new statute. Now, when taxpayers genuinely do not understand a tax statute they have little respect for it. Indeed, when the taxable income is measured by technical rules, which quite often look arbitrary, it is most difficult to regard a taxpayer as a "tax avoider" as long as he plays strictly by the set of rules laid down by the legislature. An attempt to resort to a general anti-avoidance provision of the law to counteract tax planning can be of little help because it could be hard to distinguish between a loophole and a trap.

It is not even easy to blame unsophisticated taxpayers who resort to tax evasion because they feel that in any case they cannot comply with the inflation legislation and are bound to be taxed unjustly unless they evade.

Another effect of the adjustment-to-inflation legislation has been the growing need to resort to the services of accountants and rely on their opinion. Hence, in the rivalry which undeniably exists between the legal profession and the accountants over supremacy in the tax area, the new legislation lends great support to the accountants.

It remains to be seen how the new statutes will be interpreted by the courts of law which are composed of judges who had legal training, but are not accountants. So far it appears that the disputes between the taxpayers and the Treasury tend to be settled out of court.

In interpreting the provisions of the Income Tax Ordinance the Israeli courts have generally followed the accepted principles of accounting; however, they felt free to depart from them occasionally. Also, the courts do not tend to adhere to the rule of strict construction when interpreting taxing provisions any more; in a growing number of cases they prefer to give effect to the "object of the legislation". It seems that they may be hard pressed to adopt a similar attitude when faced with the interpretation of a highly technical legislation such as the inflation legislation. A further study of this subject, however, would be outside the scope of this review.

The Measurement of Business Income

By R. Mansury

Part II
Information and Practice

III. THE PRACTICE IN INDONESIAN LEGISLATION

1. General

In dealing with the business income measurement in practice in the Indonesian legislation, my discussion is divided into two parts: the practice before and the practice after the 1983 tax reform that became effective on 1 January 1984.

Before the 1983 tax reform, the provisions which applied to individual taxpayers were different than those which applied to entities, therefore the discussion of the period before 1 January 1984 is separated into the business income measurement for individual taxpayers and that for corporate taxpayers.

2. Before 1 January 1984

a. The individual income tax

a.1. *The definition of business*

The definition of "business" used before 1 January 1984 is that still used in the implementation of the Income Tax Law 1984.

Business income is income derived from business activities. What are business activities? The law gives a definition of business, i.e. "doing business is performing activities in the economic and social field continuously, and a profit motive is not a requirement or a condition to the definition of doing business".[33] "Business activities are activities in the economic and social field that are related to each other and which are performed continuously. Continuous activities that are not related to each other are not considered as business activities."[34]

The distinction between business income (or professional income) and other income is important, because only when net business income (or net professional income) is determined is there an allowance for depreciation.

To decide whether income is business income or another type of income, two tests are often used:

1. The *number of transactions test:* when the transactions occur frequently, then there is a business; when a transaction occurs only once, it would be difficult to say that there is a business.
2. The *organization test:* the existence of a division between management and labor is decisive in determining whether there is a business or not.

a.2. *The principles to measure business income*

The measurement of business income was performed on the basis of a broad concept, the so-called good-business-practice principle. The broad concept was inherited from Dutch accounting principles.[35] Under this concept, there was no clear-cut limit of what was allowed by good business practice and what was not allowed. As there were no generally accepted standards, the principles that were applied to measure business income were too subjective. This concept was too vague to be implemented properly.[36]

The business income or profit was measured as the difference between sales price and the historical cost. Replacement cost was not allowed to be used for tax purposes. In other words, the measurement of individual business income for tax purposes under the Income Tax Ordinance 1944 was basically adopted from the traditional accounting income measurement with all its characteristics such as past actual transactions, the period postulate, the historical cost principle, and the realization criterion.

a.3. *Deductions*

Deductible business expenditures were distinguished by two categories: operational expenditures and depreciation expenses.

Operational expenditures were expenditures consumed or used within the tax year. These expenditures included the expenses of obtaining, collecting, and conserving the income and the expenses burdening such income. These included cost of material, wages and salaries, and insurance premiums and administrative costs that would be of benefit for only one tax year. Losses resulting from bad debts were also deductible as operational expenditure in the tax year in which the account receivable was in fact unable to be collected. The bad debts had to be written off in accordance with good business practice.

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33. Wibisono, Gunawan, Pajak Pendapatan, Jakarta: no publisher (1977) at 58.
34. Id.
35. Hadibroto, Suhadji, *A Comparative Study of American and Dutch Accountancy and their Impact on the Profession in Indonesian,* Jakarta: Lembaga Penerbit Fakultas Ekonomi, Universitas Indonesia (1975) at 46-97.
36. Id. at 174.

Depreciation expenses were a portion of expenditures incurred to obtain an asset that would be a benefit to the business for more than one tax year. The portion of the expenditures that was allowed to be deducted from the gross income of a particular tax year was deemed to be those expenses incurred to obtain, collect, and conserve the income of that particular year.

The Personal Income Tax Ordinance 1944 provided only that the depreciation expenses were to be deducted in accordance with good business practice, without any further provisions. There were no provisions on the method of depreciation to be used (the straight-line, the double-declining balance, or the sum-of-years-digits method),[37] nor on the rates of depreciation. These were left wholly to good business practice, so that were was no concrete set of standards on how to measure depreciation expenses. Such a situation could lead very easily to disputes between tax inspectors and taxpayers on whether the measurement of business income was correct.

The Personal Income Tax Ordinance 1944 also provided that no deduction was allowed for expenditure on the purchase and improvement of land, buildings, equipment, and other assets which were used in conducting a business. So, a distinction was made between operational expenses (in which maintenance expenses were included) and acquisition or improvement costs. The first were deductible from the gross income of the tax year in which they were incurred, while the second were depreciated over the years according to their useful life.

b. The corporation tax

b.1. *The definition of business*

The defintion of "business" in the Corporation Tax Ordinance 1925 is the same as the definition of "business" in the Personal Income Tax Ordinance 1944, as described above.

For corporation tax purposes, the distinction between business income and other income was not only important in determining net business income for which a depreciation allowance was available, but also in determining whether an association (whose capital was not divided into shares) or a "foundation" was subject to tax or not. Such an association or a foundation was only subject to corporation tax when the organization derived business income from sources other than a business exclusively serving the public interest. When the organization obtained income from a business that exclusively served the public interest, it was not subject to corporation tax.

b.2. *The principles to measure business income*

Corporate income is not necessarily always business income, because income derived by a corporation might also be investment income. Under the Corporation Tax Ordinance 1925, investment income was the income derived from capital invested outside the business of the corporation and both investment and business income were subject to corporation tax.

Business income was defined in the negative. The Corporation Tax Ordinance 1925 only defined what was non-business income, so that any income that was not non-business income was business income.

Income derived from capital invested outside the business of the corporation was non-business income. Income other than that derived from capital used outside the business of the corporation was business income.

The Corporation Tax Ordinance 1925 did not draw a very sharp line between business income and non-business income, except in the two cases explained above: the depreciation allowance, and the determination of whether an association or foundation was taxable.

In addition to the specific rules to determine taxable income (see below), the Corporation Tax Ordinance 1925 adopted two general principles:
- the substance-over-form principle; and
- the good-business-practice principle.

In accordance with the substance-over-form principle, the name or the form of a transaction was not important. The most important consideration in determining whether or not there was income was the substance of the transactions. When the substance of the transaction was an income-creating transaction, then the income had to be measured.

The following illustration will suffice to explain how the name of a transaction would not be of major importance. A company car with the book value of 10,000 was sold to a shareholder, owning most of the shares of the company, for 10,000. Thus it seemed that no income was produced, because the selling price was 10,000 and the book value was also 10,000. Hence the company could say that the transaction was "a transaction with no profit". However, the fair market price of the same car at the time of the transaction was 15,000. On the basis of the substance of the transaction, as the company and the major shareholder were related persons, the selling price had to be adjusted to the arm's length selling price of 15,000. Income of 5,000 then had to be recognized and measured (15,000 minus 10,000). So, even if there were no income recorded in the accounting of the company, for corporation tax purposes, an income of 5,000 should be measured and included in the taxable income of the company in the year of the transaction. Thus it can be seen that the name given by the company was not the deciding factor, rather it was the substance that was decisive.

The good-business-practice principle was only applied to areas in which there were no specific rules given by the Corporation Tax Ordinance 1925. One of these areas was the valuation of property held at the end of the fiscal year.

Even if there were not specific rule in the Corporation Tax Ordinance 1925, sometimes the courts would determine that the intention of the law was not to accept

37. Musgrave, Richard A. and Peggy Musgrave, *Public Finance in Theory and Practice*, New York: Mc.Graw-Hill Book Company (1980), at 414.

a particular valuation. If one of the most important decisions, the court held that the Corporation Tax Ordinance 1925 required that the business income be determined on the basis of historical costs and not on the basis of current costs or replacement costs. It did not allow the application of replacement costs accounting to determine taxable business income.

Merchandise could be valued by one of these three methods:[38]
(1) at cost;
(2) at the market price; or
(3) at the lower of cost or market price.

The taxpayer was allowed to choose one of the three methods but once a method was chosen, it had to be used consistently.

Accounts receivable had to be valued at nominal (face) value. Under the good-business-practice concept, a probable loss had to be recognized due to the fact that not all accounts receivable were collectible. For corporation tax purposes, the corporate taxpayers that attached audited financial statements to their returns were allowed to deduct an estimated loss on uncollectible accounts of 3% of the average of the beginning and end balances of accounts receivable. In other words, the 3% was deducted as an allowance for uncollectibles or as an estimated loss on uncollectible accounts.

As for foreign exchanges, in general, they had to be valued at the market rate at the end of the fiscal year. An exception to this rule was when the foreign exchanges were owned as merchandise, as in the case of foreign exchanges owned by a money changer. In such a case, they had to be valued as merchandise, and the taxpayer was allowed to choose one of the above three valuation methods. The valuation of securities or shares was made in relation to the purpose for which they were held. When securities or shares where held for purposes of control or to assist in establishing or in maintaining good customer or supplier relations, they had to be valued at cost, but when securities were held only to make use of some idle money and were to be converted into cash, when cash was required, they were valued at the lower of cost or market.

b.3. *Specific rules*

Contrary to the two rather vague general principles, the specific rules outlined in the Corporate Tax Ordinance 1925 governed the calculation of taxable income or taxable profits for particular areas. These rules had to be used or to be taken into consideration in determining taxable income.

The specific rules are summarized as follows:

b.3.1. Corporation tax had to be levied and the taxable income had to be calculated on the basis of a financial year.

The financial year consisted of exactly 12 consecutive calendar months.

For a company that had just started or one that was to be closed down, the financial year would usually be less or more than 12 months. In such cases, the calculation of taxable income had to be made in accordance with the calendar year or a portion of the calendar year.

b.3.2. In calculating net taxable income, the gross income had to be reduced by the cost of obtaining, collecting, and conserving such income.

This rule allowed corporate taxpayers, in computing net taxable income, to deduct all costs or expenses that were directly related to the production of the income from gross income, Only the costs that were related to the production of income of the particular year were allowed to be deducted. The use of the income or profit was not deductible.

As no specific accounting method to reach the net taxable income was required, the taxpayer was at liberty to adopt any accounting method,' as long as the net taxable income was able to be determined from the books of account.

The books of account kept by the taxpayer had to contain: (1) a continuous record of the cash position; (2) regularly kept statements of accounts receivable and accounts payable; and (3) at the end of every year, the books had to be closed by drawing up the balance sheet and profit and loss account.

Whether the taxpayer was required to adopt cash accounting or accrual accounting was dependent on the line magnitude of the business. In accordance with good business practice, professional practices and small businesses could use cash accounting. Where prepayments and accruals were significant in amount and varied from period to period, that method of income measurement could result in serious distortions, therefore good business practice called for the appropriate recognition of those items by the adoption of accrual accounting.

b.3.3. Organization expenses and costs of any increase of capital were allowed to be amortized in accordance with the books of account. The real reason such liberty was given to the taxpayer was because the amount of the organization's expenses and the costs of capital increase were ordinarily not very high.

b.3.4. Costs of obtaining, collecting, and conserving income with a useful life of more than one year and capital costs were depreciated over a number of years.

The term "depreciation expenses" was used to refer to the deductible items consisting of the following:
- improvement and other expenditures that were useful for more than one year; and
- capital expenditures.

both deducted over the years according to their useful life.

In the implementation of depreciation, no distinction was made between improvement expenditures with a useful life of more than one year and capital expendi-

38. Soemitro, R. Rochmat, *Penuntun Perseroan Terbatas degan Undang-Undang Pajaki Perseroan,* Bandung: N.V. Eresco (1959), at 96.

tures. Both were depreciated under the same method over their respective useful life.

Improvement expenditures and other expenditures that were usually consumed within one tax year, but which, in fact, had a useful life of more than one year, were not allowed to be totally deducted in the current tax year, but had to be depreciated over the years in accordance with their useful life.

The same rule applied to the capital expenditures, which were expenditures to acquire new property with a useful life of more than one year. They too had to be depreciated over their useful life rather than be treated as an expense in the tax year of expenditure.

The depreciation method that was required was the straight-line method. All expenditures with a useful life of more than one year were classified according to their character into particular categories.

If so desired, sub-categories could be formed within each group so that expenditures within an equal range of depreciation periods might be grouped together. The depreciation of the classified expenditures was deducted in equal amounts, beginning with the year in which the expenditures were made, continuing for as many years as was specified for the group or sub-group.

The commencement of the depreciation allowance might be postponed to a later year provided notice of such postponement was filed with the tax return.

b.3.5. New corporations that invested their capital in a field of production of accordance with government priorities were granted a tax holiday, for a period not exceeding 6 years, commencing with the year in which commercial production started.

There were a number of priority sectors for industrial undertakings:
- agricultural, integrated forestry, integrated fishery, livestock, and other land-resource undertakings as well as manufacturing industries for machinery, and undertakings for processing products;
- industries processing more domestic raw materials than imported raw materials;
- forward and backward linking industries;
- fully integrated textile industries, outside Java, both for natural and man-made fibre;
- chemical industries;
- medical instruments and pharmaceutical industries processing at least one basic raw material;
- transport industries with a substantial share of economic development.

b.3.6. In the event that a tax holiday was not granted to a new corporation, an investment allowance could be deducted from income.

This investment allowance was a deduction of 5% per year of investment expenditures in computing net taxable income spread over four years; the total amount, therefore, was 20%.

New additional investment, made by a corporation granted a tax holiday, made the corporation eligible for an investment allowance applicable to the years after the tax holiday terminated.

b.3.7. Corporations to which a tax holiday or an investment allowance was granted were also eligible for accelerated depreciation. Accelerated depreciation was an additional depreciation deductible in computing net taxable income each year, for 4 successive years, beginning with the year in which a qualifying expenditure was made.

Qualifying expenditures were expenditures on equipment which directly increased the productivity of business carried on by the corporation granted a tax holiday or an investment allowance in the field of manufacturing, agriculture, mining, or transportation, with the exception of:

(a) expenditures on business equipment that had previously been used in Indonesia;
(b) expenditures that were considered luxury expenditures by the tax inspector.

The amount of accelerated depreciation was:
(1) 10% of expenditures on permanent buildings;
(2) 25% of expenditures on other capital goods.

3. From 1 January 1984

a. *General*

In the new Income Tax Law 1984, in force since 1 January 1984, all kinds of income, either earned by an individual or by a corporation, in principle, are treated similarly. As it does not distinguish between business income earned by an individual and that earned by a corporation, the new system is simpler than the old one.

There are two main differences in computing net taxable income for an individual and for a corporation:

(1) employment income can only be earned by an individual and never by a corporation; and
(2) exempt income can only be deducted in computing net taxable income of an individual, the amount of the exempt income is dependent on the marital status of the taxpayer and the number of dependents.

b. *The definition of business*

There is also no definition of what is meant by "business", "business activities" and "business income" in the Income Tax Law 1984.

In practice, the tax administration has used the definition developed under the Corporation Tax Ordinance 1925 and the Personal Income Tax Ordinance 1944 that doing business is performing activities in the economic and social field continuously and that the continuous activities must be related to each other. Whether or not there is a profit motive is not important.

It should be noted that two aspects that were important in the old system, as set forth hereafter, are now les important:

(1) *A foundation*

A foundation will be exempt from income tax not only on income of business exclusively serving the public interest, but also on capital income or investment income received from sources other than those exclusively serving the public interest as long as such income is used exclusively in the public interest.

(2) *Depreciation allowance*

The assets that are depreciable are not only those used in business, but also those used for the production of income other than business income.

The following aspects, concerning business income, have increased in importance.

(a) A resident taxpayer earning business income or professional income is required to keep complete books of account in Indonesia from which income subject to income tax can be calculated.

(b) The income tax collection on imports and payments from the Government Treasury is a collection on business income. In other words, when the imports are not part of business activities, or when the payments are not for goods and services used as part of business activities, the imports and the payments are not subject to tax collection under this law.

c. *Two different measurements of business income*

The new Income Tax Law 1984 divides taxpayers into two groups:
(1) taxpayers with gross revenue or gross receipts of less than 60,000,000 Rp.; and
(2) taxpayers with gross revenue or gross receipts of 60,000,000 Rp., or more.

The division of taxpayers into these two groups was done because not all taxpayer receiving or accruing business and professional income have the ability to provide full books of account.

Although the ideal is for all taxpayers to keep proper books, taking into account the difficulty to the Indonesian small businessman (i.e. the lack of bookkeeping knowledge, and the inability to pay the expenses necessary to prepare such books), a single income group was deemed unwise at this time.

d. *Calculation norms*

Taxpayers owning small amounts are given an option, in calculating their net income, to use calculation norms or to keep full books of account.

Calculation norms are guides used to determine net income for every type of business. They are calculated, published, and continuously updated by the Director General of Taxation. The following points should be noted concerning their use:

(1) Calculation norms are used *in lieu of* actual income, but they are not used *to determine* actual income. The norms are different from the standard assessment guides in the Israeli system, called "tachshiv",[39] which are used to produce an assessment nearest to the actual income through best judgement.

(2) Calculation norms can only be used by taxpayers whose gross revenue from their business is not more than 60,000,000 Rp. The calculation norms are intended to narrow the avenue for tax evasion. When a taxpayer chooses to use calculation norms he must communicate such a choice to the Director General of Taxation within the first 3 months of the tax year.

Taxpayers with gross revenue of 60,000,000 Rp. or more are only allowed to use calculation norms if they pay a penalty. These taxpayers may use the calculations norms, provided they add 50% to the tax calculated from the norms.

(3) Once a small taxpayer has chosen to keep full books of account, he must continue keeping full books. This is only logical, as, once a taxpayer is able to keep proper books, he can no longer claim that he is unable to keep such books.

(4) The taxpayer is not given the right to rebut the calculation norms and prove actual income. The reasons for this are as follows:
- The taxpayer is the one who chooses to apply the calculation norms. Since the calculation norms are published before the tax year, the taxpayer should have known in advance the advantage of using the norms.
- When a taxpayer considers the norm applied to his type of business disadvantageous to him, he may choose to keep full books of account instead; he is allowed to calculate his actual income in accordance with his books.

(5) It can be seen from the above, that the calculation norms are used to encourage taxpayers to keep full books of account.

(6) The small taxpayer, using calculation norms in computing his net income, is not exempted altogether from the obligation to keep records, as he is still required to keep a record of turnover or gross receipts. If he does not meet the requirements, his turnover or gross receipts will be estimated and his net income will be computed by applying the corresponding net income norm to the estimated turnover. The tax on this deemed income shall have a penalty of 50% added to it.

e. *The measurement of business income from full books of account*

The first measurement of business income is made by applying norms, the second measurement by computing net taxable income from full books of account.

39. Lapidoth, Arye, The Use of Estimation for the Assessment of Taxable Business Income, *Bulletin for International Fiscal Documentation* (1977), at 27, Amsterdam: International Bureau of Fiscal Documentation.

The measurement of business income based on full books of account is applied per the divisions resulting from the Income Tax Law 1984.

The requirements relating to books of account that must be met under the Income Tax Law 1984 are that:

(1) the books of account must be kept in a manner that net income subject to income tax can be calculated;
(2) the books of account must contain, at a minimum: (i) orderly records of cash and bank transactions, (ii) accounts receivable and payable, and (iii) an inventory.
(3) at the end of each tax year, the taxpayer must close the books by preparing a balance sheet and an income statement based on accounting principles consistent with those used in the previous year. The position of the tax administration is that any principles which are generally used and not contradictory to the provisions of the law are permitted. The Generally Accepted Accounting Principles (GAAP) adopted by the Association of Indonesian Accountants are acceptable. The new specific rules are designed to attain simplicity and ease of administration. How these two objectives are to be attained is explained below.

The specific rules applicable in computing business income from the full books of account are as follows:

e.1. The Income Tax Law 1984 pertains to the financial year as does the taxable income to be calculated.

This provision is exactly the same as the one in the Corporation Tax Ordinance 1925. It is different from the one in the Income Tax Ordinance 1944, which was always levied on a calendar year basis and not for any financial year other than the calendar year.

Simplicity is attained by treating the busines income earned by an individual or by a corporation in the same way.

e.2. In computing net income, gross income is reduced by the cost of obtaining, collecting, and conserving such income.

This rule is, in general, similar to that in the Corporation Tax Ordinance 1925 and the Personal Income Tax Ordinance 1944, but in detail there is an important difference in the treatment of fringe benefit costs.

Under the new system, fringe benefits provided by the taxpayer as an employer for the needs of the employees, including for the use of automobiles and housing, are not deductible in computing net income. The exception to this rule is the cost for housing in an isolated area.

So, even though the principal rule is similar to the one in the old system, there is a sub-rule under the new system for implementing the principal rule that differs substantially from the old system. Even though, under the new system, costs of obtaining, collecting, and conserving income are, in principle, deductible, costs for fringe benefits are excluded and are not deductible in computing net income.

There is no specific rule on expenses incurred to set up a corporation and on the costs of any increase in capital. It can be assumed that such expenses and costs are treated, for tax purposes, in accordance with good business practice.

e.3. Costs to obtain tangible business property are depreciated; costs to obtain rights and other costs with a useful life of more than one year are amortized.

The new depreciation method and the depreciation rates under the new system are altogether different from those under the old system.

The Income Tax Law 1984 system of depreciation is based on open-ended depreciation accounts in which assets within a certain range of useful life are consolidated.

All assets, except buildings and other immovable property, are grouped into three classes:
- Class 1: depreciable property with a useful life of not more than 4 years.
- Class 2: depreciable property with a useful life of more than 4 years, but not more than 8 years.
- Class 3: depreciable property with a useful life of more than 8 years.

The rates of depreciation per year for non-building classes are: class 1 = 50%; class 2 = 25%; and class 3 = 10%.

Taxpayers are required to use a single open-ended group account for all machinery and equipment in each class. The amount of machinery and equipment acquired during the year is added to the adjusted basis of the account. In the case of the retirement of property:

(a) if extraordinary, as a result of casualty or termination of a large segment of business, the total remaining book value may be deducted from the opening value in determining the depreciation base, and the total remaining books value may be considered as a loss in the relevant tax year, whereas proceeds from sale or insurance proceeds shall be considered income; and
(b) if ordinary, meaning for reasons other than those mentioned in (a), such as a sale of property, net proceeds from such a sale shall be deducted from the opening value in determining the depreciation base.

Calculation of class 2 property can be illustrated by the following example:

– opening value for a tax year	100,000
– machinery and equipment acquired during the year	+ 60,000
– adjusted basis before depreciation	160,000
– multiplied by the depreciation rate of 25%	x 0.25
– allowable depreciation	(40,000)
– opening depreciation base for the next year (160,000 – 40,000)	= 120,000

If, during the next year, the proceeds from a sale of an asset are 10,000 and assets are acquired at 30,000, the calculation will be as follows:

– opening value	120,000
– proceeds from a sale	– 10,000
	110,000
– asets acquired	+ 30,000
– adjusted basis before depreciation	140,000
– times depreciation rate of 25%	x 0.25
– allowable depreciation	(35,000)
– closing value at the end of next year (140,000 – 35,000)	= 105,000

Each building or other immovable property and any additions, improvements, or alterations carried out thereon are depreciated in a separate item account. Major additions, improvements, or alterations are also depreciated in separate accounts. Depreciation is computed using the straight-line method and assuming a 20-year life. Thus, 5% of the original cost is written off each year.

e.4. Costs of obtaining title to mining and forestry rights are amortized by applying the unit of production method, which means that the percentage amortized each year equals the percentage of production in the year concerned subtracted from the estimated total production, but in no case more than 20%.

e.5. In contrast to other mining sectors, costs of obtaininhg rights in the oil and gas sector are deductible using the unit of production method without any by percentage restrictions.

e.6. There are generally 3 categories of inventory: finished goods, goods in process, and raw materials. In all three categories the average cost or first-in / first-out (FIFO) method is permitted. The LIFO (last-in / first-out) method is not permitted for tax purposes.

e.7. Under a Government Regulation, banks are allowed a tax deductible reserve. The reserve or allowance permitted is 6% or 3% of the average of opening and closing balances of accounts receivable. Six percent is applicable to state banks which give much riskier loans than those given by private banks and 3% is applicable to private banks.

IV. CONCLUSION

The traditional accounting business income measurement adopting the historical cost basis is the least costly, as it is less open to dispute than any other measurement for its verifiability, and the easiest to prepare.

Since tax disputes are costly in social terms, such disputes are to be avoided as much as possible. Such disputes in the measurement of taxable business income can be eliminated or mitigated when the outcome of the measurement is verifiable and the measurement itself is based on objective yardsticks. In other words, a measurement that does not create or provide certainties should not be used for tax purposes.

As the traditional accounting income measurement is based on past actual transactions, on historical costs and on the realization criterion, it is more certain, objective, and verifiable.

Under the Indonesian income tax system there is no need to make a distinction between income items earned from production activities and gains from mere holding, since both items are treated similarly. This distinction may be important to the management of the firm in making business decisions, but it is not important for tax purposes.

The traditional accounting measurement of business income, with its three main characteristics: (1) the actual transactions basis; (2) the historical cost principle; and (3) the realization criterion, is the most appropriate measurement for tax purposes. This conclusion does not necessarily lead to an acceptance of all the GAAP adopted by the Association of Accountants, but only of these three characteristics.

Accounting income measured by using the GAAP is not and cannot be synonymous with taxable income computed by applying rules under the Income Tax Law 1984, as the objectives of financial acounting are different from those of tax accounting.[40]

The GAAP are directed toward producing financial statements of a business that present fairly the financial position at a particular point of time and results of operations for the book year ending at that time. Substantial changes have occurred and will always occur in financial accounting principles because of the continuous process of change in business practices and techniques, which means the financial accounting principles have to be adjusted to this development or to new circumstances.[41]

The objectives of the current Indonesian *tax* accounting are those underlying the Indonesian tax reform of 1983, now incorporated in the Income Tax Law of 1984. Those objectives are:

(1) To collect needed government revenue in an equitable way. The tax base should be broadened by adopting a progressive rate structure, under which, in principle, all categories of income are taxed.

(2) To simplify the income tax system by reducing the present number of tax brackets into only three and by denying deductibility to amounts spent by an employer to purchase fringe benefits provided to employees for personal use (in other words, rather than tax the taxpayer-employee for the benefits, the employer is simply prohibited from deducting the cost of such benefits given to the employee).

(3) To achieve certainty by making special provisions for the areas that, under the old system, created

40. Knechtel, Ronald C., "Role of the GAAP in Determining Income for Tax Purposes", in Report of Proceedings of the 31st Tax Conference convened by the Canadian Tax Foundation, 26-28 November 1979, Toronto: Canadian Tax Foundation (1980), at 846.
41. Ibid. pp. 845-846.

many disputes between taxpayers and tax inspectors.

(4) To remove loopholes used for evasion. (The system of calculation norms is intended to narrow the avenue for tax evasion. The authority provided to the Director General of Taxation to reallocate income or expenses to reflect income accurately is also designed to control prices charged on flows of goods and services between affiliates.)

Traditional accounting, with the three main principles, is appropriate for tax purposes with an understanding that other accounting principles can only be applied in tax accounting as long as they are not at variance with the provisions of the Inome Tax Law 1984 and will not damage the attainment of the objectives of the tax policy underlying the design of the tax system already incorporated in the tax law. The provisions of the law are already stated in the law itself, but the objectives of the tax policy, even though already incorporated in the law, are not always easily traced in the words of the law. To avoid difficulties in implementing the law, the tax administration must issue a ruling on every actual case questioned by a taxpayer, a trade or business association, the Association of Accountants, a public accountant, or a tax consultant. Any position of the tax administration challenged by a taxpayer should be brought to tax court and a decision should be given by the tax judge to eliminate any doubt or uncertainty.

The accounting methods introduced in the new law for taxpayers whose gross revenue or gross receipt is less than 60,000 Rp. recognize the inability of this sector to keep full books of record by giving them an optional right to measure their business or professional income with calculation norms. Calculation norms are in fact ratios of net profits or net income to gross revenue or gross receipt prepared on an industry-to-industry basis (each industry is designated its own ratio or norm). My view about the adoption of the calculation norms system can be described as follows:

(1) To force all taxpayer with small businesses to keep full books of account is impossible, as a very large number of them are in fact unable to do so. But they should not be exempt altogether from the obligation to keep records of their business or profession, given the case of a business whose gross revenue or gross receipt is less than 60,000 Rp. but which has the ability to keep full books of account. This group of taxpayers is encouraged to be taxed on their income measured from their books of record. To offer this incentive, the norms are constructed from ratios of excellent and efficient taxpayers, so that businessmen with lower performance rates should prefer to measure their net business income from their books. The application of this system is a ncessary step to ensure that accounts-based income taxation reaches as many taxpayers as possible.

(2) This system is also a helpful device to determine the net taxable income of hard-to-tax taxpayers who do not want to prepare proper records of their business or who do not want to show their records. As the norms are carefully prepared and based on efficient businesses, they are the most effective devices in Indonesia to distribute the tax burden in a equitable manner. Small taxpayers who opt for applying norms are required by law to maintain a simple record of gross receipts, on the basis of which net income is computed. Large taxpayers whose gross revenue is 60,000 Rp. or more, but who do not keep proper books of account, will be audited and assessed, and the tax assessment shall be increased by a penalty of 50% of the underpaid income tax. When the audit results in a lower income tax than the income tax calculated by applying norms, the norms are applied. Small taxpayers who do not comply with the requirement to maintain a simple record of gross sales will be assessed by using another set of norms to determine gross sales and the tax shall also be increased by a penalty of 50%.

(3) the calculation-norms system will eliminate or mitigate bargaining practices that previously took place to the detriment of society or government revenue. By publishing the norms and opening them to criticism by society, they will be improved.

If the government can adhere to its policy of verification and objectivity and administer guidelines for the classification of income in an equally objective manner, the Income Tax Law 1984 will increase revenue and provide certainty to the taxpayer. Clear rulings, stating which of the GAAPs are acceptable, will allow for greater respect and easier compliance by taxpayers. The success of the new legislation will require support from both sides of the tax system, the taxpayer and the administration. As can be determined from the above, the Indonesian tax system must develop a precise set of accounting principles to achieve any of the goals of income taxation.

Conference Diary

APRIL 1986

British Branch of I.F.A.: Tax workshop (subject of topical interest to be chosen shortly before the meeting). London (United Kingdom), 2 April (English).

European Study Conferences Limited: Share schemes – U.K. practice after the 1986 Budget. London (United Kingdom), 8 April (English).

Nederlands Studie Centrum: Innovatieve beloningsmethoden (new remuneration methods) (including: capital appreciation as remuneration, evaluation problems from tax-point viewed). Rotterdam (Netherlands), 9 April (Dutch).

City Business Courses: Tax planning for the single contract self-employed. London (United Kingdom), 15 April (English).

Neue Wirtschafts-Briefe: International tax law (including recent tax cases). Essen (German Federal Republic), 17 April (German).

European Study Conferences Limited: VAT: dramatic changes and perpetual oversight. London (United Kingdom), 22 April (English).

Ecole supérieure des sciences fiscales: European taxation and investment (including: tax measures or incentives encouraging investment in the following countries: German Federal Republic, Belgium, France, Italy, United Kingdom, The Netherlands, Luxembourg and Spain). The Commission of the European Economic Community will deliver a report. Brussels (Belgium), 25 and 26 April (English and French).

City Business Courses: Taxation briefing for non tax bankers. London (United Kingdom), 29 April (English).

The World Trade Institute: Corporate tax developments (including: fringe benefits) (Seminar). New York (U.S.A.), 28 and 29 April (English).

MAY 1986

The World Trade Institute: Introduction to international taxation (Seminar). Boston (U.S.A.), 5 and 6 May (English).

British Branch of I.F.A.: Recent tax cases. London (United Kingdom), 6 May (English).

The World Trade Institute: U.S. and international tax planning for high technology ventures (Seminar). Boston (U.S.A.), 5 and 6 May (English).

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).

The World Trade Institute: Earnings and profits of foreign subsidiaries (Seminar). New York (U.S.A.), 8 and 9 May (English).

The World Trade Institute: Tax aspects of intercompany pricing (Seminar). San Francisco (U.S.A.), 19 and 20 May (English).

British Branch of I.F.A.: International tax implications of investment into and out of Japan. London (United Kingdom), 21 May (English).

Gesellschaft für Unternehmerinformation mbH: Einführung in die Praxis des Internationalen Steuerrechts (Introduction to the practice of international tax law). Bonn (German Federal Republic), 22 and 23 April (German).

BNA International Inc.: The 12th biannual Tax Management International Forum (Conference); The Impact of the U.S. Tax Reform Act on International Business Transactions. London (United Kingdom), 22 May (English).

The World Trade Institute: Foreign tax credit (Seminar). San Francisco (U.S.A.), 22 and 23 May (English).

The World Trade Institute: Update on current issues in international taxation (Seminar). New York (U.S.A.), 29 and 30 May (English).

JUNE 1986

The World Trade Institute: Legal and tax aspects of foreign investment in U.S. real property (Seminar). New York (U.S.A.), 9 and 10 June (English).

The Worl Trade Institute: Tax planning under Subpart F (Seminar). New York (U.S.A.), 12 and 13 June (English).

The World Trade Institute: Legal and tax aspects of compensating foreign nationals in the United States (Seminar). New York (U.S.A.), 16 and 17 June (English).

The World Trade Institute: Tax aspects of international treaties (Seminar). New York (U.S.A.), 16 and 17 June (English).

The World Trade Institute: Introduction to international taxation (Seminar). Chicago (U.S.A.), 23 and 24 June (English).

The World Trade Institute: Foreign tax planning (Seminar). Chicago (U.S.A.), 23 and 24 June (English).

The World Trade Institute: Expatriate tax policies and planning (Seminar). Chicago (U.S.A.), 25-27 June (English).

The World Trade Institute: Intermediate Seminar on international taxation (Seminar). Chicago (U.S.A.), 25-27 June (English).

The World Trade Institute: Foreign sales corporations (Seminar). Chicago (U.S.A.), 26-27 June (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).

Bureau of European Taxation & Trade: The taxation of overseas partnerships in Europe. London (United Kingdom), 29 September (English).

FOR FURTHER INFORMATION PLEASE WRITE TO:

BNA International Inc., 17 Dartmouth Street, London
SW 1H 9BL, England

British Branch of I.F.A., P.O. Box 68, Unilever House, Blackfriars, London EC 4P 4BY, United Kingdom.

Bureau of European Taxation & Trade, 606 Bryer Court, Barbican City, London EC 2Y 8DE, United Kingdom.

City Business Courses, 21 The Barton, Cobham, Surrey KT 11 2NJ, United Kingdom.

Ecole Supérieure des sciences fiscales, Boulevard Brand Whitlock 6, 1150 Brussels, Belgium.

European Study Conferences Limited, Kirby House, 31 High Street East, Uppingham, Rutland, Leics LE 15 9PY, United Kingdom.

Gesellschaft für Unternehmerinformation mbH, Mecklenburger Strasse 5, PF 240124, 5300 Bonn 2, German Federal Republic.

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.

Münchner Steuerfachtagung, c/o Prof. Dr. Klaus Vogel, Ludwigstrasse 28, Rückgeb., 8000 München 22, German Federal Republic.

Nederlands Studie Centrum, Schiedamseweg 36, 3130 AH Vlaardingen.

Oracle Business Information, 21 The Barton, Cobham, Surrey KT 11 2NJ, United Kingdom.

Seminar Services International, Boulevard de Pérolles 7a, CH-1700 Fribourg, Switzerland.

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The World Trade Institute, One World Trade Center, 55th Floor, New York, N.Y. 10048, U.S.A.

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Books

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

To facilitate ordering, a list of addresses of the main publishing houses is included on pages 43-44 of the January 1986 issue. Addresses of publishers which do not appear in this list are indicated in the item concerned.

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CUMULATIVE INDEX 1986 – Nos. 1-2

I. ARTICLES:

II. REPORTS AND DOCUMENTS

III. IFA NEWS

IV. CONFERENCE DIARY

V. BIBLIOGRAPHY

Contents

of the April/May 1986 issue

ERRATUM

In the article by Mr. H.M.A.L. Hamaekers in the March 1986 issue, "Multilateral Instruments on the Avoidance of Double Taxation", the last sentence on page 104 was improperly printed. Please place a period behind the word "party" and delete the words ". . . like the U.S. Model".

INHALTSVERZEICHNIS

SOMMAIRE

Basic Structure of the Foreign Tax Credit System of Japan

by Hiroshi Kaneko

Professor Kaneko is presently teaching at the University of Tokyo. He was a Rockefeller Foundation Grantee from 1961-63 at Harvard Law School, studying United States tax law. He returned to Harvard under a grant from the Japanese Government in 1976 for one year. In 1979 he was at Boalt Hall, University of California researching corporate income tax laws of Japan and the United States. Professor Kaneko is President of the Japanese Society for Tax Law and a member of the Tax Policy Committee for the Japanese Government, as well as many other distinguished organizations. It is an honor to publish the English version of this article which was previously published in French in Economica in a special issue in honor of Professor Paul Marie Gaudemet (1984).

I. INTRODUCTION

In the Japanese tax system, foreign source income is included in the tax base the same as domestic source income, for both corporate and individual income taxes (hereafter the "world-wide system"). In order to avoid international double taxation under the world-wide system, both Corporation Tax Law (hereafter "CTL") and Personal Income Tax Law (hereafter "ITL") adopt two alternatives. One alternative is the deduction of foreign tax as an expense in computing net income (CTL Sec. 41, ITL Sec. 46), and the other is a credit of foreign tax against Japanese tax which is computed with the inclusion of foreign source income in the tax base[1] (CTL Sec. 69, ITL Sec. 95). Since the first alternative gives greater benefit to taxpayers only in exceptional cases, the second alternative is usually chosen by taxpayers. The foreign tax credit method is adopted for Japanese taxpayers in tax treaties concluded by Japan to avoid international double taxation (for instance, the Netherlands–Japan Treaty Section 24(1)).

This combination of the world-wide system and the foreign tax credit method is based on the idea that this is a better means than the exemption of foreign source income from the tax base to maintain equality between taxpayers who do business or invest in the domestic market and taxpayers who do business or invest in the foreign market, as well as to maintain neutrality in the tax system between business activities and investment in the domestic economy and those in foreign countries. Therefore, it could be said that the Japanese tax system is based on the notion of capital-export neutrality, not capital-import neutrality.[2]

The structure of the present foreign tax credit system was formulated in 1962 by amendments to CTL and ITL.[3] By that time, the Japanese economy had already recovered from the severe damage caused by the Second World War, and had begun to grow rapidly. In the process of this development, an increase of mutual trade and investment between foreign countries was assumed indispensable for the economic growth of Japan. Therefore, the Japanese Government took positive steps to open the Japanese market internationally as well as to encourage Japanese enterprises to do business and invest in foreign markets. As one of these steps, attempts were made to eliminate tax barriers and deterrents and to make the tax system more favorable for foreign trade and investment. The foreign tax credit system was an important factor in these attempts.

Even before 1962, Japan had used the foreign tax credit method. However, the system was simple and primitive. For instance, the scope of the creditable foreign tax was not always clear. Also, the per-country limitation method was used concerning limitation of credit. These elements were thought to be deterrents to business activities and capital investments in foreign countries. The amendment of 1962 was to change this situation. The system adopted by this amendment was very advanced and generous in avoiding international double taxation. It could perhaps be said that the Japanese system was the most advanced and generous in the world at that time. Since it was too generous in some respects, amendments were made in 1983 to bring the system more in line with international standards.

The purpose of this article is to introduce the Japanese system of foreign tax credit to tax scholars and specialists of foreign countries. Part II will outline the system and Part III will introduce some recent amendments. Part IV will describe a problem that needs to be solved in the future.

There are two interesting problems in the Japanese

1. Concerning the foreign tax credit system of Japan, cf. M. Takeda, *Corporation Tax Law*, 489 et seq. (1983); Y. Komatsu, *International Taxation*, 116 et seq. (1983); T. Honjo and N. Nishikawa, *Knowledge of Taxation on International Transactions*, 423 et seq. (1975); Y. Watanabe, *Foreign Tax Credit*, 3 ed. (1980).
2. Concerning notions of capital-export neutrality and capital-import neutrality, cf., M. Sato and R.M. Bird, *International Aspect of the Taxation of Corporations and Shareholders*, 22 IMF Staff Papers Vol. 22, no. 2 (1975).
3. Concerning the amendment of 1962, cf. Y. Ueno, Amendment of Provisions concerning International Taxation, in National Tax Administration Agency, 1962 *Amendments of Tax Law*, 60 et seq. (1962); M. Takeda, *Taxation of Foreign Corporations and Foreign Tax Credit*, Zeimu Tsushin, no. 705, 30 et seq. (1962).

foreign tax credit system; one is the tax-sparing credit clause in treaties with developing nations,[4] and the other is the anti-tax haven legislation of 1979.[5] However, these problems are omitted in this article. The writer will publish separate articles on these problems in the future.

Since the structure of the foreign tax credit system is basically the same for both corporation tax and income tax, the description hereafter will be limited to the case of corporations.

II. OUTLINE OF THE SYSTEM

In Japan, corporation tax is imposed by the national government on the taxable income of corporations at a rate of 42% for retained income and 32% for income paid out as dividends[6] (CTL Sec. 66(1), Special Tax Treatments Law Sec. 42). Prefectures and local communities also impose a surcharge on the corporation tax at rates of 5% and 12.3% respectively (hereafter "local corporation tax") (Local Tax Law (hereafter "LTL") Secs. 51, 314-6). These rates for local corporation tax are standard rates. Prefectures and local communities can adopt different rates, so long as they do not exceed 6% and 14.7% respectively.

Taxable income of corporations is basically the excess of gross revenue over expense (CTL Sec. 22). As mentioned before, Japanese corporations should include their foreign source income in the tax base, and can credit "foreign corporation tax" against Japanese corporation tax and local corporation tax (CTL Sec. 69, LTL Secs. 53(8), 221-8(8)).
In this Part, three basic problems will be discussed.

1. Creditable foreign taxes

CTL defines "foreign corporation tax" as taxes imposed by foreign governments which are, as determined by Cabinet Order, equivalent to Japanese corporation tax[7] (Sec. 69(1)). By means of this delegated power, the Cabinet Order to Enforce CTL (hereafter "CTLCO") provides that foreign corporation tax means taxes imposed on the income of Japanese corporations by foreign national and local governments based on statute, order or other forms of law (Sec. 141(1)).

CTLCO also provides that the following taxes are included in foreign corporation tax (Sec. 141(2)).

1. Excess profits tax and other taxes on particular portions of corporation income.
2. Surtax on tax which is imposed on corporation income or particular portions thereof.
3. Tax which belongs to the same item as corporation income tax and which is imposed, for the convenience of assessment and enforcement, on gross revenue or the equivalent thereto, instead of net profit, of particular income of the corporations as the tax base. Withholding tax on interest, dividend, etc. is an example of this tax.
4. Tax imposed on gross revenue or equivalent thereto in lieu of tax on net income. This means so-called "in-lieu tax".

In order for a levy by a foreign government to be credited, it should be tax in its nature; that is to say, the nature, not the name of the levy, is controlling. Three examples will be described here. First, additions, interests or fines for non-observance of tax law or tax evasion are not creditable, even if they are named "tax" (interest tax, addition tax, etc.) in the statute (CTLCO Sec. 141(3)). Second, government debt which is compulsorily raised under the name of "tax" is not creditable, as far as the government is obliged to refund it in the future. Third, foreign tax which is in its nature the price for a privilege or a special right, such as a mining right, can not be credited.

Some developing countries calculate the amount of corporation tax by applying a certain percentage to gross revenue or gross sales instead of applying a tax rate to net income. This is an example of an in-lieu tax. Incidentally, the unitary tax of California and some other states of the United States is not an in-lieu tax, but a corporation income tax in itself. Only the method of calculation of net income is special. In order for a foreign tax to be creditable as an in-lieu tax, a corporation income tax should exist and a substitution relation between the two taxes.

2. Limitation of credit

As in other countries, the Japanese tax system limits the amount of foreign tax credit. This is based on two rationales.[8] The first is that such a limitation is necessary to protect the tax revenue of Japanese Governments (both national and local). The second is that it is necessary to prevent other countries (especially developing countries) from keeping their tax rates high, and consequently to mitigate tax barriers to international trade and investment.

The limitation adopted by Japan is the so-called overall limitation, not per-country limitation. The amount of the limitation is the part of national and local corporation taxes which corresponds to foreign source income (CTLCO Sec. 142(1), LTLCO Secs. 9-7(4), 48-13(5)). Therefore, the formulas for calculating the limitation are as follows:

(a) Formula for national corporation tax

$$\text{amount of corporation tax} \times \frac{\text{total foreign source income}}{\text{total income subject to corporation tax}}$$

4. Cf. H. Kaneko, *Tax-Sparing Credit Clause in Tax Treaties*, in 1 Kohogaku Kenkyu for the Celebration of Professor S. Sugimura's Seventieth Birthday, 1, 167 et seq. (1973).
5. Cf. Y. Ishiyama, in *Recourse to Tax Havens – Use and Abuse*, IFA Seminar Paper, 67 et seq. (1980).
6. These rates are increased to 43.3% and 33.3% as a temporary measure until 31 March 1987.
7. Concerning the scope of foreign corporation tax, cf. Watanabe, op. cit., 30 et seq.; H. Kaneko, *Foreign Tax Credit System of Japan*, 10 Tax Law Review 90 et seq. (1982).
8. Cf. Kaneko, id., 192 et seq.

(b) Formula for prefectural corporation tax

amount of (a) above $\times \frac{5}{100}$

(c) Formula for local communities corporation tax

amount of (a) above $\times \frac{12.3}{100}$

When local corporation tax is imposed at a rate higher than the standard rates, as mentioned before, corporations can at their option calculate the amount of limitation using the higher rate they actually adopted (LTLCO Secs. 9-7(4), 48-13(5), each proviso).

Creditable foreign tax should first be credited against national corporation tax to the extent of the limitation amount of (a) above (CTL Sec. 69(1)). If the amount of creditable foreign tax exceeds the amount of (a), the excess amount is to be credited against prefectural corporation tax to the extent of the amount of (b) above (LTL Sec. 59(8), and then against local communities corporation tax to the extent of the amount of (c) above (LTL Sec. 321-8(8)).

Two measures are adopted to eliminate international double taxation as completely as possible. First, if the amount of the creditable foreign tax exceeds in a year the aggregate amount of the limitations of the formulas of (a), (b) and (c) above, the excess amount is still creditable against the corporation tax of the same year to the extent of the amount of "unused limitation" (the amount of excess of the limitation over the creditable foreign tax) of the five preceding years (CTL Sec. 69(2), CTLCO Secs. 143, 144, LTLCO Secs. 9-7(4), 48-13(5). This measure is called "carryforward of unused limitation". The function of this measure is the same as that of carrying back of the excess amount to the five preceding years. However, the method is completely different from the carryback of the excess amount. The reason why carryforward of the unused limitation is adopted instead of carryback of the excess amount, is to avoid the re-opening of the account and the re-calculation of tax liability for past years.[9] This system is convenient for both the taxpayers and the tax administration. If this is a unique system of Japan, it is worthy of attention from the viewpoint of comparative tax policy. Second, if the excess amount still remains after the carrying forward the unused limitation above, the excess amount can be carried forward to five succeeding years (CTL Sec. 69(3), CTLCO Sec. 145, LTCCO Secs. 9-7(2), 48-13(2)). Thus, Japanese corporations can offset the excess of creditable foreign tax over the limitation with the unused limitations of ten other years, altogether. From the viewpoint of comparative tax law, perhaps this is the most lenient system in the world.

Incidentally, when the amount of creditable foreign tax within the amount of limitation exceeds the amount of corporation tax, corporations can claim a refund of the excess amount (CTL Secs. 74(1)(iii), 79).

It is necessary to make some comments concerning the limitation formula of (a) above. First, national corporation tax means only normal corporation tax and does not include the special tax on retained earnings of family corporations or the special excess tax on short-term capital gains on the sale of land. Second, the amount of total income subject to corporations tax (the denominator) is different from the concept of taxable income of corporations in one respect: it is the amount before the deduction of net-loss carried over from previous years (CTLCO Sec. 142(2)). This is based on the consideration that it is difficult, in a practical sense, to allocate net loss of past years between domestic and foreign source incomes. Third, CTLCO provides that foreign source income is all income other than domestic source income (Sec. 142(3)). The scope of domestic source income is provided by Section 138 of CTL. Therefore, the scope of foreign source income is decided by this provision. This means that the scope of foreign source income is decided by source rules of Japan, not of foreign countries.[10] Also, the amount of foreign source income is calculated according to Japanese law, not the law of foreign countries[11] (CTLCO Sec. 142(3)). A description will be given in Part III below of some important points concerning the scope and calculation of foreign source income.

3. Indirect foreign tax credit

In order to maintain equality between taxpayers and the neutrality of the tax system, with regard to business activities of domestic corporations in foreign countries, it is necessary to treat equally corporations that establish branches and those that establish subsidiaries. For that reason, since 1962 Japan has adopted the so-called indirect foreign tax credit, under which domestic corporations can deem as paid by themselves the portion of foreign corporation tax paid by their subsidiaries corresponding to dividends they receive, and credit it against their Japanese corporation tax (CTL Sec. 69(4)).

Corporations can get indirect foreign tax credit only when two requirements are satisfied (CTL Sec. 69(4), CTLCO Sec. 146).

First, corporations should hold at least 25% of their subsidiaries voting shares or paid-in capital, continuously for at least six months before dividends are declared. Therefore, Japan follows the OECD Model Convention in this regard. Though there is opinion in Japan that the 25% holding rate is too high, and that it should be replaced for instance by a 10% holding rate as in the United States system, it seems that the possibility of such an amendment is very slight.[12] Instead, it is the policy of Japan to reduce the holding rate by tax treaty when it is necessary. For instance, the tax treaty with the United States adopts a 10% rate.

Second, foreign subsidiaries should not be corporations which do not carry on business by themselves, or

9. Cf. id., 104.
10. Watanabe, op. cit., 50 et seq.
11. Ibid. 65 et seq.
12. Kaneko, op. cit., 101.

which are established primarily for abatement of the tax burden. The purpose of this requirement is to prevent tax avoidance.[13]

The amount of the portion of foreign corporation tax paid by subsidiaries corresponding to dividends (the amount of indirectly creditable foreign corporation tax) is calculated according to the following formula (CTLCO Sec. 147(1)):

$$F \times \frac{\text{dividends received}}{I - F}$$

where I = income of foreign subsidiaries
F = foreign corporation tax on foreign subsidiaries

For the indirect credit, the same rules as for direct credit are applied in the definition of creditable foreign corporation tax, limitation of credit, carryforward of unused limitation, carryforward of excess of creditable foreign tax over limitation, and refund of excess of creditable foreign tax over Japanese corporation tax. Needless to say, since creditable foreign corporation tax of subsidiaries is deemed to have been paid by parent corporations, the amount thereof should be grossed up to the tax base of the latter (CTL Sec. 28).

III. SOME RECENT AMENDMENTS

Three important amendments were made in 1983 concerning the scope and calculation of foreign source income.[14] An outline of these amendments will be provided here.

1. Treatment of net loss in one country

Under the over-all limitation method, the net loss produced in one foreign country should be offset with net profit produced in other countries in the calculation of the amount of total foreign source income. However, in the system prior to the 1983 amendment, corporations were given the option of offsetting net loss in one country with net profit in other countries or ignoring the net loss (CTLCO Sec. 142(3) proviso). This was a remnant of the per-country limitation system prior to 1962, and worked to increase the amount of the numerator of the formula of (a) in II-2 above by the amount of net loss, and consequently increase the amount of limitation of credit, compared to a case in which net loss was offset with net profit. Therefore, this was a deviation from the principle of over-all limitation.[15] Also, it favored corporations that do business in more than one country against those that do business only in one country. For these reasons, the option above was abolished by the 1983 amendment, and now corporations should offset net loss in one country with net profit of other countries in calculating the total foreign source income (CTLCO Sec. 142(3)).

13. Watanabe, op. cit., 133 et seq.
14. Concerning the amendment of 1983, cf. Note, Amendment of Provisions of CTLCO concerning Foreign Tax Credit, 3 Journal of International Taxation, no. 4, 20 et seq. (1983); S. Odajima, Amendment of Computation of Foreign Source Income in Foreign Tax Credit System, 3 Journal of International Taxation, no. 5, 11 et seq. (1983).
15. Kaneko, op. cit., 103 et seq.
16. Note, Journal of International Taxation, op. cit., 22 et seq.

2. Source of income from sale of movable inventories

Under Japanese source rules, income from the sale of movable inventories has its source at the place of sale (CTL Sec. 138(i), CTLCO Secs. 176(1), 141(3)). Until 1983, it was provided that the place of sale was deemed to be outside of Japan, and, consequently, income therefrom was foreign source income if one of the following three requirements was satisfied (CTLCO Secs. 176(4), 142(4)).

1. The inventory was located outside of Japan, immediately before the sale.
2. Contract of sale was concluded outside of Japan.
3. An important part (e.g. negotiation) of the activities for concluding the contract were performed outside of Japan.

Under this treatment, the amount of the numerator and consequently the amount of limitation of credit of the formula of (a) in II-2 above was apt to increase. However, many countries, including Japan, adopt, for business income of foreign corporations, the so-called "no taxation without permanent establishment" principle by either domestic law or treaty. Consequently, Japanese corporations are not taxed by foreign countries that adopt the above principle on income from the sale of inventories, unless they have a permanent establishment in these countries, even if one of the above-mentioned requirements is satisfied. Therefore, the treatment above was not only too generous, giving improper and unnecessary benefit to corporations, but contrary to the generally accepted principles of international taxation.

For that reason, the above treatment was abolished by the 1983 amendment, and a new rule was adopted,[16] under which income from the sale of inventories is treated as foreign-source income only if the sale is carried out through a permanent establishment located outside of Japan (CTLCO Sec. 142(4)(i)(a)). However, some countries do not adopt the "no taxation without permanent establishment" principle and impose tax on income from the sale of inventories of foreign corporations even if they do not have a permanent establishment within their jurisdiction. Taking this possibility into account, it is also provided that corporations can at their option treat the income from the sale of inventories as foreign source income, when foreign corporation tax is imposed thereon, even if the sale is not carried out through a permanent establishment located outside of Japan (id. (b)).

As a result of this amendment, it could be said that the Japanese system in this regard is now in line with the general principle of foreign tax credit.

3. Allocation of expenses

Needless to say, expenses necessary to produce foreign-source income of domestic corporations should be deducted in calculating the amount thereof. The most difficult problem here is how to allocate expenses that are common to both domestic and foreign activities such as general management expense and sales promotion expense (hereafter "common expenses"), between domestic and foreign source incomes.

The Japanese tax system was very vague on this matter until the amendment of 1983.[17] There was no provision for this in either statute or cabinet and ministerial orders. Though there was a ruling on this matter, its contents were general and vague. It provided that, first, of the headquarter expenses of corporations expended in each accounting year (expenses which corporations expend for the function of general control and supervision of branches, and which can not be attributed solely to a particular branch), the amount appropriately apportioned in their accounting as attributable to foreign source income is included in expense in the calculation of the amount thereof, and, second, the amount of common expenses apportioned by corporations in their accounting to foreign source income will be accepted as appropriate by Japanese tax authorities, when the amount was treated as expense by the source country in computing its corporation tax, unless such treatment has harmful tax effects (National Tax Administration Agency, Basic Rulings on Corporation Tax (hereafter "CTBR") 16-12-14).

Since this ruling was too vague and did not have clear standards, it could not give precise guidelines, and was apt to give discretion to corporations concerning the allocation of common expenses. Therefore, the allocation of common expenses varied from corporation to corporation[18] (lack of uniformity), and it was quite possible that unnecessary benefit was afforded to corporations by increasing the amount of the numerator and consequently the amount of limitation of credit of the formula (a) in II-2 above.

To respond to these problems, a new rule was adopted in 1983 by amendment to CTLCO. Section 142(6) thereof provides that common expenses should be allocated according to a standard which can be recognized as rational in view of the contents of business of corporations and the nature of expenses such as the amount of gross receipts, the amount of assets, and the number of employees. This provision apparently offers clearer and more concrete standards than the old ruling above. However, since there are ambiguities about interpretation thereof, the National Tax Administration Agency issued rulings to maintain uniformity between corporations.[19] Without going into detail, these rulings can be summarized as follows.

First, concerning common expenses other than interest expense, when it is difficult to calculate for each item thereof the amount to be allocated to foreign source income, the allocable amount should be decided as a general rule by multiplying (a) the entire amount of common expenses by (b) the ratio of the amount of total sales profit from foreign activities to the amount of total sales profit of the corporation (for interests, dividends and royalties, the amount of receipts) (CTBR 16-3-10).

Second, concerning interest expense, other than that directly attributable to foreign business activities (hereafter "common interest expense") of wholesale or manufacturing business corporations, the allocable amount should be decided as a general rule by multiplying (a) the total amount of common interest expense by (b) the ratio of the amount of book value of the assets for foreign business activities to the book value of all assets of the corporation (CTBR 16-3-11(1)).

Third, concerning common interest expense of banking business corporations, the allocable amount should be decided as a general rule by applying (a) the average interest rate of borrowed money and deposits to (b) the amount of the average balance of loans outstanding and securities held by the corporation which produce foreign source income (id. (2)).

Fourth, concerning common interest expense of corporations whose business is other than wholesale, manufacturing and banking, allocation should be made by one of the two methods above (id. (3)).

Fifth, when none of the three methods mentioned above accords with the contents of the business of corporations, with prior consent of the tax authorities, all or part of common expenses or common interest expense can be allocated according to a standard which can be recognized to accord with the contents of the business such as amount of receipts, amount of direct expense, market value of assets, and number of employees (CTBR 16-3-12).

Owing to the amendment above, corporations are now granted higher predictability concerning the allocation of common expenses. Also, the allocation will be more in line with the generally accepted principle of foreign tax credit. However, the new rule could work injuriously to corporations when source countries do not approve the allocation of common expenses in computing the amount of their corporation tax.

All three of the above-mentioned amendments aim to make the Japanese foreign tax credit system more equal and neutral, and more in line with the general principles of international taxation and foreign tax credit. However, it should be noted at the same time that the Japanese Government has been suffering serious financial deficits in recent years due to a slowdown of economic growth since the oil shock, and that these amendments were part of various attempts by the Government to increase its revenue.

IV. SUMMARY AND A PROBLEM THAT REMAINS

As mentioned above, Japan has a rather advanced and elaborate system of foreign tax credit. Until recently, it had some lenient elements which deviated from gen-

17. Cf. ibid., 23 et seq.; Watanabe, op. cit., 69 et seq.
18. Cf. Note, Journal of International Taxation, op. cit., 24.
19. Concerning these rulings, cf. T. Toshima, *Concerning Amendments of Basic Rulings on Corporation Tax* (1), Zeimu Tsushin no. 1797, 13 (1983).

eral principles of foreign tax credit. These elements were a part of the Japanese Government's economic policy to encourage foreign trade and investment and, ultimately, higher economic growth.[20] However, responding to various criticisms and the necessity to increase revenue, these elements were either abolished or altered by the amendment of 1983 as above. As a result of this amendment, the Japanese system is now more equitable and better accords with general principles of foreign tax credit.

However, some problems still remain to be solved in the future. Of these, only one, which deserves special mention, will be discussed here.

In contrast to the lenient elements mentioned above, there has been an overly strict element in the Japanese system. Under the indirect foreign tax credit system of Japan, corporations can credit only the tax paid by first-tier subsidiaries (direct subsidiaries), and can not credit the tax paid by subsidiaries in other tiers. Under this system, international double taxation can not be avoided satisfactorily. Therefore, this system can work inequitably. For instance, when a foreign subsidiary of a Japanese corporation establishes a subsidiary in a third country, the corporation tax of the subsidiary can be reduced as a result to the third country. Therefore, the Japanese corporation can credit only this reduced amount of the tax of the subsidiary, and international double taxation remains as a possibility. If the tax rate of the third country is high, the amount of foreign tax that can not be credited and, consequently, the degree of international double taxation that remains could be substantial.

Thus, this system is also a deviation from the general principles of foreign tax credit, because it is not in accordance with the purpose of foreign tax credit – avoidance of international double taxation – and is against the principles of equality and neutrality.[21] Therefore, the author believes that Japan should amend this system so that corporations can credit not only the tax paid by first-tier subsidiaries, but also the tax paid by subsidiaries in other tiers. The justification of the present system, that it could have the favorable effect of discouraging corporations from being multinationalized is not very persuasive. Certainly, from the viewpoint of administrative feasibility, it would not be practical to permit the credit of the tax of subsidiaries of all tiers without limitation. However, it would be feasible to permit the credit of the tax of second- and third-tier subsidiaries in addition to that of first-tier subsidiaries as in the United States, or at least to permit the credit of the tax of second-tier subsidiaries in addition to that of first-tier subsidiaries as in West Germany.

20. However, it should be noted that the Japanese tax system has been generous also to foreign corporations in some respects. For instance, Japan has for many years adopted the principle of "No taxation without permanent establishment" by domestic law.
21. Kaneko, op. cit., 101 et seq.

In next issues:

Long-term fiscal policy 1985 – Its bearing on direct taxes in India – by *Parimal M. Parikh*

A summary of Singapore's 1986 Budget – by *Lee Fook Hong*

Hong Kong: The UMELCO Report

The Argentine income tax reform – by *Pedro Massone*

South Africa: The 1986 income tax changes – by *Erwin Spiro*

PEOPLE'S REPUBLIC OF CHINA:

New Regulations on Foreign Exchange Balancing in Joint Ventures

By Charles D. Toy*

China's State Council promulgated on January 15, 1986 new "Regulations of the State Council Regarding the Question of the Foreign Exchange Balances of Joint Ventures Using Chinese and Foreign Investment". The new Regulations were put into force on February 1, 1986.

The Regulations are appicable to Chinese-foreign cooperative joint ventures as well as equity joint ventures established within China, but do not apply to financial and insurance enterprises established within China by foreign joint-venture parties. Specific provisions include the following:

- In general, the Chinese authority which approves the establishment of a joint venture will be responsible for resolving foreign exchange income and expenditure imbalances suffered by such joint venture. However, the Regulations are not clear as to how any such authority is to reach any such resolution.
- Joint ventures producing highly sophisticated products with advanced or key technology, or top quality products competitive in the international market which are badly in need domestically, may receive preferential treatment with respect to the percentage of production to be sold on the Chinese domestic market and the duration of such sales – provided that such matters are specifically covered in relevant contracts. However, it is not expressly stipulated in the Regulations that any such domestic sales shall be for foreign exchange.
- Joint ventures manufacturing products which need to be imported into China on either a long-term or urgent basis may have such products treated as import substitutes, provided such treatment is specified in the relevant contracts. Again, it is not explicitly stated in the Regulations that any products sold as import substitutes shall be paid for in foreign exchange.
- Joint ventures may export products produced domestically but not by such joint ventures in order to generate additional foreign exchange for such joint ventures. However, it should be noted that, under other regulations, products already being exported by Chinese foreign trade corporations may not be procured in China by joint ventures for such export resale.
- Products sold by joint ventures to enterprises which are outside the Special Economic Zones and the Economic and Technological Development Zones of open coastal cities and which have foreign exchange payment capability may be paid for in foreign exchange. The Regulations do not, however, require any such enterprise to participate in any such sale.
- A foreign joint-venture party with two or more joint ventures in China may resolve a foreign exchange imbalance in once such joint venture with foreign exchange surpluses from the other(s), provided that all joint-venture parties involved agree to such resolution.
- Joint venture profits taken in renminbi and re-invested in domestic enterprises will result in a refund of 40% of any income tax paid under the "Income Tax Law of the People's Republic of China Concerning Joint Ventures Using Chinese and Foreign Investment".

Promulgation of the Regulations would appear to be acknowledgment by Chinese authorities of the problems which have existed for foreign investors in or negotiating joint ventures which are projected to have difficulties generating sufficient income in foreign exchange to meet their foreign exchange expenditure requirements. Domestic sales of import substitutes for foreign exchange, exports of products other than those produced by the entity in question for additional foreign exchange, and additional investment in other joint ventures which can generate foreign exchange are among the possible solutions to such problems suggested by the Regulations. The shortcoming of the Regulations is, however, the absence of concrete rules or measures for implementing such suggestions. For example, the power of approving authorities to resolve foreign exchange imbalances "by adjusting among the foreign exchange incomes of joint ventures" approved by such authorities is not established by the Regulations, nor are the specific sources of foreign exchange which would be used to adjust for any imbalance identified. More importantly, the various general sources of additional foreign exchange pointed to by the Regulations would appear to be real sources only to the extent the relevant Chinese parties in possession of such foreign exchange agree to or acquiesce in the necessary expenditure or transfer of foreign exchange – domestic sales for foreign exchange requires specific agreement by domestic purchasers to buy using their own foreign exchange; the sale of products as import substitutes similarly requires specific agreement by

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purchasers with the necessary foreign exchange that they will pay in foreign exchange; and use of any foreign exchange surplus in one joint venture to resolve a foreign exchange imbalance in another joint venture requires the specific agreement of all joint-venture parties, including those on the Chinese side. In each of the foregoing cases, the relevant entity in possession of or with control over foreign exchange would appear to have no special incentive to agree to or acquiesce in the respective expenditure or transfer of such foreign exchange, and the Regulations carry no mandate for any entity so to agree or acquiesce.

Nevertheless, to take full advantage of the limited substance of the Regulations, foreign investors should be prepared for detailed discussions with their Chinese counterparts in all negotiations on the contracts documenting their relationship. All joint venture and other contracts should spell out concretely and carefully how the respective parties thereto intend to earn or otherwise obtain and spend foreign exchange.

REGULATIONS OF THE STATE COUNCIL REGARDING THE QUESTION OF THE FOREIGN EXCHANGE BALANCES OF JOINT VENTURES USING CHINESE AND FOREIGN INVESTMENT*

Promulgated by the State Council on January 15, 1986

Article 1

These Regulations are formulated in order to encourage foreign joint-venture parties to establish joint ventures using Chinese and foreign investment in China and to promote balances in their foreign income and expenditures, so as to facilitate their production operations and to facilitate the remittance abroad of the legal profits of foreign joint-venture parties.

Article 2

Products produced by joint ventures using Chinese and foreign investment should be more highly exported, creating more foreign exchange and achieving balances in foreign exchange income and expenditures.

Article 3

If an adjustment of the foreign exchange income and expenditures of a legally approved joint venture using Chinese and foreign investment becomes necessary, it should be categorized and resolved in accordance with the jurisdiction of examination and approval authorities.

For a joint venture using Chinese and foreign investment the establishment of which was approved by competent authorities at the national level, such competent authorities at the national level shall be responsible for a resolution by adjusting among the foreign exchange incomes of joint ventures using Chinese and foreign investment in the entire country. Such resolution may also be achieved under an adjustment ratio decided upon after consultation between such competent authorities at the national level and local People's governments. For a joint venture using Chinese and foreign investment the establishment of which was approved by a local People's government authorized by the State Council or entrusted by competent authorities at the national level, or by a relevant department of the State Council, such local People's government or department shall be responsible for a resolution by adjusting among the foreign exchange incomes of joint ventures using Chinese and foreign investment respectively approved.

Article 4

Highly sophisticated products produced with advanced technology or key technology provided by a foreign joint-venture party, or top quality products competitive in the international market, if badly in need domestically, may be given preferential treatment in the areas of the ratio of domestic sales and the time limit of domestic sales, after being determined to be up to standard by competent departments, and after being approved in accordance with examination and approval jurisdictions and examination and approval procedures stipulated by the State. Such domestic sales should be specified in contracts between producers and purchasers.

The foreign exchange balancing measures of an enterprise of the preceding clause shall, in accordance with Article 3, Clause 2 of these Regulations, be formulated by approval authorities. The foreign exchange balancing measures formulated by such approval authorities shall arrive at a resolution, in accordance with administrative procedures, after being submitted to the Ministry of Foreign Economic Relations and Trade or local economic relations and trade departments for examination and opinions, reported to the State Planning Commission or local planning commissions for approval, and thereafter included in long-term or annual foreign exchange expenditure plans.

Article 5

Products produced by a joint venture using Chinese and foreign investment which need to be imported on either a long-term or urgent basis may, in accordance with the quality, specification requirements and import conditions of such products, and after approval by the competent departments of the State Council or local competent departments, be treated as import substitutes. Such substitution shall be specified in joint venture contracts of joint ventures using Chinese and foreign investment or in contracts between producers and the purchasers.

Economic and trade departments shall actively encourage domestic users to enter into purchase contracts based on international prices with joint ventures using Chinese and foreign investment decribed in the preceding clause. Their foreign exchange expenditure measures should be formulated in accordance with Article 3, Clause 2 of these Regulations, and shall arrive at a resolution, in accordance with administrative procedures, after being submitted to the Ministry of Foreign Economic Relations and Trade or local economic relations and trade departments for examination and opinions, reported to the State Planning Commission or local planning commissions for approval, and thereafter included in long-term or annual foreign exchange expenditure plans.

Article 6

In order to achieve a balance in foreign exchange income and expenditures, a joint venture using Chinese and foreign invest-

(*) Translated by Kaye, Scholer, Fierman, Hays & Handler, 02/17/86 translation.

ment may, after approval from foreign economic relations and trade departments, export domestic products by utilizing the sales connections of its foreign joint-venture party, and implement comprehensive compensation. However, for products which are under state monopoly, have export quotas, or require export licenses, special approval from the Ministry of Foreign Economic Relations and Trade is required.

Article 7

If a joint venture using Chinese and foreign investment has not fulfilled obligations to export and to generate foreign exchange stipulated in its contract, and as a result creates an imbalance in foreign exchange income and expenditures, the relevant authorities shall not be responsible for any adjustment or resolution.

Article 8

Products sold by joint ventures using Chinese and foreign investment to the enterprises with foreign exchange payment capability outside special economic zones and the economic and technological development zones of open coastal cities, upon approval by state exchange control departments, may be paid for with foreign currency.

Article 9

A foreign joint-venture party which has established two or more joint ventures using Chinese and foreign investment in China (including in different locations and in different industries), if its shares of legally obtained foreign exchange show surpluses and deficits, may, upon approval by state exchange control departments, resolve [its deficits] by adjustments among its enterprises.

The adjustments of the preceding clause shall be agreed upon by all joint-venture parties.

Article 10

After approval by foreign economic relations and trade departments and exchange control departments, a foreign joint-venture party in a joint venture using Chinese and foreign investment which cannot balance its foreign exchange income and expenditures may, in accordance with Article 7 of the "Law on Joint Ventures Using Chinese and Foreign Investment", re-invest its share of renminbi profits from such joint venture using Chinese and foreign investment in domestic enterprises which are capable of generating foreign exchange or increasing foreign exchange income. In addition to enjoying according to law the benefit of a refund of a portion of income tax already paid, it may also gain foreign exchange from the newly increased foreign exchange receipts of enterprises receiving such investment, and (be able to) remit its legal profits abroad.

Article 11

These Regulations are applicable to Chinese-foreign cooperative joint ventures established within China, as well as (equity) joint ventures and cooperative joint ventures established within China by companies, enterprises and other economic organizations from Hong Kong, Macau and Taiwan areas. They are also applicable to (equity) joint ventures and cooperative joint ventures established by investment by overseas Chinese.

These Regulations are not applicable to financial and insurance enterprises established within China by foreign joint-venture parties, or to such enterprises established within China by joint-venture parties from Hong Kong, Macau and Taiwan areas.

Article 12

In the event of any conflict between these Regulations and regulations concerning foreign exchange income and expenditure balances of joint ventures using Chinese and foreign investment existing prior to the promulgation of these Regulations, these Regulations shall prevail.

Article 13

These Regulations shall be interpreted by the Ministry of Foreign Economic Relations and Trade.

Article 14

These Regulations shall be put into force on February 1, 1986.

INDIA:

Budget 1986/87

By Kailash C. Khanna

A few weeks before the presentation of the Union Budget for the fiscal year 1986/87, the Government of India announced a steep hike in the administered prices of all petroleum products, including kerosene, cooking gas and diesel oil. Prior to this hike, the government increased the controlled prices of coal, fertilisers and some cereals. Thus, the rise in the prices of petrol goods acted as the proverbial last straw on the camel's back. There were countrywide protest rallies and strikes and a considerable hue and cry was raised against what was regarded as a wholly unjustifiable and unethical action of the government; unjustifiable because oil prices were tumbling in the international market and unethical because the increase was effected through an administrative fiat shortly before Parliament was due to meet. The government's plea of curbing oil imports did not carry conviction and even a reduction in the increase announced earlier failed to pacify the public and the critics.

Apparently, the youthful Prime Minister's young government was somewhat unnerved and on 28 February, the Finance Minister, Mr. V.P. Singh, made the longest Budget speech on record, lasting over two hours, taxing the listeners' patience and displaying a vague zeal for the anti-poverty cause. Thus, the outlay for the major rural development programmes is proposed to be stepped up by 65%, unfortunately, in absolute terms, even this "quantum jump" means an allocation of a meager 15,000 million Rs., a sum too small to be really effective in the uplift of millions of rural people who live below the poverty line. Several programmes for improving the lot of the city slum-dweller have also been suggested; these include soft loans for the self-employed cobblers, barbers, hawkers, and cart-pullers, etc.; accident insurance for municipal sweepers and railway porters; and housing for scheduled castes and tribes. While in percentage terms the allocations seem high, these are minuscule in absolute terms because of a low base and the magnitude of the problem. Consequently, these are unmeaningful gestures to the poor with no significant addition to productive assets or employment. Official evaluation reports have indicated that only 30 to 40% of the funds allocated reach the target groups, that there is seepage of funds all along the way and that achievement is hampered by the absence of matching infrastructure. Larger allocations for the anti-poverty programme have accordingly been dubbed "political tranquilisers"; the oldest and the leading national daily, *The Times of India*, has been constrained to comment: "In the thirty-nine years that this country has been independent, no government has used the Budget to make so blatant a play for popularity as that of Mr. Rajiv Gandhi in the second year of its office."

An enduring welfare state is possible only when poverty alleviation programmes are integrated with a growth model. There has to be a balance between productive and non-productive sectors. If productive sectors are neglected, as has been done in this Budget, there will soon be no money to finance the programmes and the popularity which the government might gain would be short lived. The entire Budget speech contains little or no reference to incentives for industrial growth and development. Instead, the emphasis is on rationalisation of the tax system and reliefs for the common man. The Budget is losing importance ever since revenue measures have been introduced in instalments of which the Budget is only one stage. This time the Budget proposals were preceded by an increase in administered prices which will yield about 15,000 million Rs. as against the yield of a little less than 5,000 million Rs. from new taxation proposals. The Budget leaves an uncovered deficit of 36,500 million Rs. which, together with the hike in prices of public sector output and services, is bound to step up inflation. It seems doubtful the Finance Minister will be able to observe the fiscal norms indicated in his framework of a long-term fiscal policy, particularly the maintenance of a close link between fiscal and monetary policy. There is bound to be some disappointment that the expectations raised by the long-term fiscal statement about the government's desire to allow a greater role for "rule-based fiscal and financial policies" have failed to materialise. Viewed against this background, the Budget for 1986/87 has received a mixed reaction. It has been called a "poor man's budget", "consolidation budget", "non-development budget", and "inflationary budget ".

So much for the general aspects of the Budget; let us now take a brief look into the specific area of taxation proposals. Referring to personal income tax, the Finance Minister has happily attributed increased collection to the lowering of the tax rates which, according to him, have led to fuller disclosures and better taxpayer compliance. While it is undeniable that lower tax burdens lessen tax evasion (some tax evasion will always take place) there is no definite evidence yet of the correctness of the Minister's claim; higher collection can be due to speedy realisation of long outstanding arrears, summary assessments, stricter enforcement of laws, extensive use of search and seizure powers and improved administration. Whether increased collection can be sustained remains to be seen. For the salaried taxpayers, the Finance Bill proposes to raise the standard deduction from 25% to 30% of salary income, subject to a ceiling of 10,000 Rs. The direct beneficiaries of this concession will be about 350,000 individuals out of a total population of about 750 million. At present, owner-occupied house property is liable to income tax on notional income subject to a maximum of 10% of the owner's total income. It is now intended to exempt such income from tax by treating the annual value of house property as nil. However, it is simultaneously proposed that no deduction shall be allowed by way of repairs, interest, insurance premiums, etc., in computing the income chargeable under the head "Income from House Property". This amendment, if adopted, will place owner occupiers, who have borrowed funds to build or buy residential accommodation or who have to carry out occasional repairs, at a disadvantage. A modification in this respect is called for.

In the field of corporate taxation, the existing surcharge of 5% on company tax is being withdrawn with effect from the 1987/88 assessment, but no change is proposed in the basic tax rates. The abolition of surtax on company profits is being postponed for another year and to this extent the expectation contained in the long-term fiscal policy is belied. Under the existing provision, the gross amount of income by way of royalty or fees for technical services received by foreign companies from an Indian concern under an approved agreement or from government is chargeable to tax at the flat rate of 40%. A lower rate of tax at 20% is, however, payable on the gross amount of such income as consists of lump sum consideration received for the transfer outside India or the imparting of information outside India in respect of any data, documentation, drawing, etc. It is proposed to charge income tax on the gross amount of income by way of royalty (including income by way of lump sum consideration) or fees for technical services included in the total income of a foreign company, at a uniform rate of 30%. This amendment will take effect from 1 April 1987 and will, accordingly, apply in relation to the assessment year 1987/88 and subsequent years. However, the change is likely to be of academic interest only as India has entered into double taxation avoidance agreements with a large number of countries and the tax rates incorporated therein are generally lower.

A retrograde suggestion is the intended withdrawal of the concessional rate of tax applicable to dividends received by a domestic company from another domestic company. At present 60% of such income is exempt from tax; henceforward the entire amount of inter-corporate dividend will be liable to the full rate of tax. This is wholly against all established rules of taxation of inter-corporate investment and will retard the promotion of affiliated and subsidiary companies. Moreover, it will lead to vast withdrawals of investments made by companies in the government owned Unit Trust and The General Insurance Corporation. The investors, the stock markets and the government institutions have strongly reacted to the proposed change and the Finance Minister has already indicated a review. Interestingly, no change is proposed in the rates of tax applicable to foreign companies on their dividend income primarily because any increase will be mostly meaningless because of double taxation treaties.

At present an investment allowance is granted at the rate of 25% of the cost of machinery and plant. In keeping with the pronouncements made in the long-term fiscal policy statement, it is proposed to withdraw the investment allowance on plant and machinery installed after 31 March 1987. In lieu thereof, it is intended to introduce an investment scheme. Under this scheme, a taxpayer who has deposited an amount out of the profits of the eligible business or profession with the Development Bank within the stipulated period of time or has utilised any amount during the previous year for the purchase of machinery and plant without making any deposit, will be allowed a deduction equal to the amount deposited or utilised, subject to an upper limit of 20% of the audited profits of the said business or profession. If an amount withdrawn from the Development Bank is not utilised for the prescribed purpose or plant and machinery acquired under the scheme is sold or transferred within 8 years of the end of the year of acquisition the unutilised amount or an amount equal to the cost of the plant and machinery, as the case may be, shall be treated as the income of the relevant year. Although details of the proposed scheme will be known later, it is apparent that the suggested incentive will be of little use to newly established or highly capital intensive industries. The amount of the deduction is linked to the profits of the relevant previous year in contrast to the investment allowance which was tied with the cost of plant and machinery. Obviously, a profit based deduction can benefit only well established, profit making on-going concerns which initiate a new project. On the other hand, the investment allowance, in a way, subsidised the initial cost of plant and machinery and encouraged the forming of new industry. The proposed scheme of investment deposit accounts needs further scrutiny if the main objective of rapid industrialisation by the formation of new units is to be achieved.

It may be relevant to mention here a proposed amendment which seeks to provide that interest payable on moneys borrowed for the acquisition of plant and machinery cannot be capitalised and added to the cost of plant after the plant has been put to use. While the amendment is in conformity with legal and accounting principles, it is inequitable to give it retrospective effect from the assessment year 1974/75. That some taxpayers, with large investments in plant and machinery through borrowd funds repayable in instalments, were merging the entire interest amount payable over the period of the loan into the cost of plant and machinery at the time of installation and claiming the investment allowance and depreciation on the enhanced costs (upheld by some courts) was known to the tax authorities for a long time. But it has taken them almost 12 years to bring forward the necessary amendment. Its retrospective operation is bound to cause limitless difficulties in implementation apart from harassment both to the taxpayers and the tax collectors in reopening part assessments. The suggested retrospective change should be given up in the interest of stability and fair play.

It is proposed to introduce a system allowing depreciation in respect of blocks of assets instead of the existing system of depreciation on individual assets. Simultaneously, a rationalisation of the structure is intended, reducing the number of rates and enhancing the same to ensure that more than 80% of the cost of plant and machinery is written off in a period of 4 years or less.

The Indian Budget 1986-87 at a glance

The Union Budget of the Central Government for the financial year beginning 1 April 1986 has been announced by the Minister of Finance. Highlights of the tax proposals include the following:

- The individual income tax rates remain unchanged;
- The 5% surcharge on income tax payable by companies will be discontinued from 1986-87.
- The planned abolition of surtax on companies (from 1987-88) has been postponed one more year, to 1988-89.
- The income withholding tax rate levied on foreign companies deriving royalties (including lump-sum considerations for transfers outside India of technical know-how) and fees for technical services has been proposed at 30% on a uniform basis (currently either 20 or 40%, depending on the case).
- The number of depreciation rates will be reduced. A system allowing depreciation in respect of blocks of assets in lieu of the present depreciation on individual assets will be introduced.
- Investment allowance will be replaced by an investment deposit scheme as from 1 April 1986 available to all taxpayers, corporate and individual. The investment deposit scheme will grant a taxpayer a deduction of 20% of the profits of the business if these are deposited with the Industrial Development Bank of India or used for purchase of plant and machinery.
- Introduction of a 5% research and development levy on all payments made for purchases of technology from abroad, including royalty payments, lump-sum payments and payments for designs and drawings. A separate bill will be introduced in Parliament for this purpose.
- The tax administration will be empowered to purchase immovable property which is offered for sale in the market at a price agreed to by the transferor, if the property value is more than 1 million rupees and is located in metropolitan cities and sold after 30 September 1986.
- The basic gift tax exemption will be increased from 5,000 to 20,000 rupees.
- Gift tax will be levied at a flat rate of 30% of the taxable gift value (rates currently range from 5 to 75%).
- Introduction of a modified value added tax (MODVAT) as from 1 March 1986 in stages. As a first measure, the MODVAT scheme will apply to products of chemical and allied industries, paints and packaging materials, plastics, glass, rubber products and base metals, etc. as specified in the Central Excise Tariff Act 1985.
- Manufacturers who fulfil the requirements will be able to set off excise duties and additional customs duties (also known as countervailing duty) paid on inputs.

This will render replacement easier and help modernisation. Buildings meant for low paid employees of industrial undertakings will be entitled to depreciation at 20%. This liberalisation of the depreciation allowance will necessitate amendments in the Companies Act, 1956, to enable companies to arrive at reasonable distributable surpluses after providing the required depreciation.

With a view to rationalise the taxation on capital gains, it is intended to advance the date for determining the cost of the capital assets from 1 January 1964, to 1 April 1974, to mitigate the hardship of inflation. Further, in the case of non-corporate taxpayers, the initial exemption limit for long-term capital gains is proposed to be raised from 5,000 Rs. to 10,000 Rs. In addition, a deduction of 50% of the long-term capital gains will be allowed in respect of buildings and lands and a 60% deduction will be permitted in relation to all other assets. In respect of long-term capital gains arising out of the transfer of gold, bullion or jewellery, the deduction will continue to be subject to a ceiling of 50,000 Rs., as at present. The existing period of one year for the purchase of a residential house, in the case where the capital gain arises on the sale of an old house, is proposed to be increased to 2 years. These are steps in the right direction, but a further review of capital gains taxation in the case of all taxpayers is necessary as stated in the long-term fiscal policy. For instance, most companies remain liable to tax on long-term capital gains at the rates of 40 and 50% which are grossly inequitable having regard to the fact that the effective corporate tax rate on normal business profits currently in force is 50% or less.

While retaining the imposition of a tax on gifts, the Finance Minister proposes to raise the basic exemption limit from Rs. 5,000 to Rs. 20,000; gift tax will be levied at a flat rate of 30% of the value of all taxable gifts. The provision relating to aggregation of gifts is intended to be withdrawn, but at the same time certain existing exemptions, such as tax free gifts to a spouse up to 50,000 Rs. and gift of insurance policy up to 10,000 Rs., are being deleted. The suggested flat 30% tax rate is too high and notwithstanding the increase in the basic exemption limit, certain gifts will bear a higher tax burden than before. The proposed tax rate of 30% needs reconsideration and reduction.

Simplified rules for the valuation of assets for purposes of a wealth tax are proposed to be notified.

In his Budget speech, the Finance Minister stated that in order to carry out surveys an amendment is being made to authorise the tax authorities to collect certain information. For this purpose, the Finance Bill seeks to insert a new section 133B in the Income-Tax Act authorising the tax authorities, down to the level of an inspector, to enter the house of any person whether taxpayer or not "between sunrise and sunset" for collecting information, but it does not prescribe the duration of the period of interrogation. The suggested provision has come in for severe condemnation at the hands of the eminent jurist Mr. N.A. Palkhivala who has called it "unconstitutional and unworthy of a democracy" as it will convert the country into a "police state". The Finance Minister has promised a review of the provision.

Likewise, the proposal empowering the government with a pre-emptive right to purchase immovable property, which is offered for sale in the market at the prices agreed to by the transferor, has been the subject of strong adverse criticism as it can affect even those cases where the property is sold at a fair market value to a friend or an associate company for absolutely bona fide reasons. Such a provision will amount to undue encroachment on the personal rights of the owners and needs reconsideration.

In order to simplify the procedure and to avoid delay and inconvenience in the case of non-resident Indians wishing to remit sale proceeds of "foreign exchange asset(s)" it is proposed that, where the sum payable to a non-resident Indian represents consideration for the transfer by him of any foreign exchange asset (other than a short-term capital asset), the authorised dealer responsible for remitting such sum shall be entitled to deduct the prescribed tax at source and remit the net proceeds.

As regards indirect taxation, the main proposal of interest is the introduction of a scheme of modified value added tax with effect from 1 March 1986. This is best explained in the Finance Minister's own words.

> This scheme, which has been referred to as a Modified Value Added Tax (MODVAT) scheme - I shall stress MODVAT, not MADVAT – allows the manufacturer to obtain instant and complete reimbursement of the excise duty paid on the components and raw materials. The MODVAT scheme provides a transparency which discloses the full taxation on the product and its introduction is an important measure of cost reduction. The amount of excise duty payable depends upon the value of the final product and the rate of duty. Introduction of MODVAT will decrease the cost of the final product considerably through the availability of instant credit for the duties paid on the inputs and a consequential reduction of interest costs. It would be noticed that the MODVAT scheme avoids the payment of duties on earlier duties paid. The payment of the duty return will be swifter as the element of excise duty will be transparent. It will, therefore, benefit both the consumers and exporters. However, in view of the novelty of the scheme, we have to move slowly and implement the MODVAT scheme in stages. As a first measure, I propose to introduce the MODVAT scheme for all goods covered by 37 specified chapters of the Central Excise Tariff Act, 1985. The Scheme as a result would cover products of chemical and allied industries, paints and packaging materials, plastics, glass and glassware, rubber products, base metals and articles of base metals, machinery and mechanical appliances including electrical equipment, motor vehicles and certain miscellaneous manufactured products. This would imply that as long as the input and the final product are covered by the specified 37 chapters and the final product bears some duty of excise, credit of duty on the inputs covered by these chapters will be available.

Even though Mr. V.P. Singh stressed that MODVAT was not MADVAT, the proposed scheme has driven the concerned suppliers, manufacturers and consumers mad and nobody knows the exact implications of the scheme despite the lapse of time since it was announced. Deliveries of materials and finished products have been disrupted. Obviously, the officials of the Department of Revenue did not do their homework properly before the announcement of the scheme. The Prime Minister has now instructed the Finance Minister to prepare a detailed explanatory note which will form the basis of discussion in Parliament. It is hoped the prevailing confusion will soon be resolved; further comment must be reserved until then. Some adjustments have been made in the rates of excise duties payable on the final product subject to MODVAT. Reduction in export/import duties have been effected for such items as unmanufactured tobacco, branded cigars and cheroots, machinery and tools for the gem and jewellery industry and this may give a slight boost to the export of these items; unfortunately the Budget contains no other incentive for the badly needed promotion of exports. To curb imports, customs duties have been raised to provide adequate support to the indigenous capital goods industry; in fact, customs duties form the main source of tax revenue in the Budget.

To conclude, the Finance Minister has, by and large, conformed to the statements made in the long-term fiscal policy. However, it is a moot point whether a long-term "moratorium" on tax rates and reliefs in a developing economy is desirable. Stability is not synonymous with rigidity and any long-term fiscal policy must allow some flexibility. Moreover, any partial stability (as in the direct tax rates) in a moving system may have the effect of destabilising everything else, unless, a composite dynamic view is taken of the whole process – fiscal, monetary and real. In addition to the long-term fiscal policy, the Finance Minister has promised a long-term administered prices policy soon; a long-term import policy was announced sometime back. As welcome as these long-term pronouncements are, care must be taken that in making these the State does not disarm itself of the economic instruments so necessary for dealing with evolving situations.

INDIA: Fiscal Incentives for the Development of Scientific Research and Locally Developed Technology

By S.N. Bhargava

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India ranks among the top twenty industrial countries of the world. It has established a sound and diversified industrial base involving sophisticated technology, and its reservoir of scientific and technological manpower is the third largest in the world, next to the U.S.A. and the U.S.S.R. The total number of economically active Science and Technology personnel in India is expected to increase to about 2,500,000 during 1985. As of 1 April 1982, about 197,000 persons were employed in research and development institutions in the country.

About 97% of the resources deployed for research and development in the world originate in 29 developed countries, most of which spend about 2.5% of their GNP on research and development. Compared to this the figure for the developing countries is about 0.5%. India devoted 0.85% of its GNP in 1982-82 to research and development and related science and technology activities in the country. The Government has recognized the importance of scientific research and development and locally developed technology for rapid economic development and self-reliance and accorded it priority. Research and development can greatly improve optimum capacity utilization in Indian industry.

If the technology is out of date, quantity and quality of goods and services are bound to suffer. The importing of technology may widen international and domestic disparities. Additionally, the importing country may not be able to utilize its own reserve of scientific and technological manpower.

Fiscal policies can be used as an effective instrument in the promotion of expenditure or investment in the development and utilization of technology, modifying the direction and speed of technological change (e.g. replacing non-renewable resources with renewable, and the promotion of socio-economic, environmental or other objectives and priorities set up by a nation. The fiscal incentives can be provided in the form of direct tax concessions or exemptions and accelerated depreciation allowances on investments for those taxpayers engaged in research and development and production activities in specified priority areas. They can also be provided in the form of indirect tax concessions or exemptions for certain goods manufactured or the corresponding inputs, when the goods in question are produced using particular technologies or fulfill other specific criteria. Generally, tax incentives are much better received by taxpayers than grants, assistance or subsidies, although the latter can be better monitored.

The allocation for science and technology in India has increased from 1420 million rupees in the Fourth Plan (1969-74) to 19,194.1 million rupees in the Sixth Plan (1980-85). The allocation for science and technology, which was 0.61% of the total outlay in the public sector in the First Plan, has become 2% in the Sixth Plan. India's expenditure for research and development and related activities in 1982-83 was 12,375.6 million rupees and in 1983-84 it was 14,300 million rupees. The allocation for research in the high technology area in 1985-86 is 5,738.5 million rupees. In addition, several fiscal incentives have been introduced under section 35 of the Indian Income Tax Act (Act) by the Government of India with a view to promote the growth of research and development in industry as well as social science or statistical research.

The Secretary, Department of Science & Technology, is the single prescribed authority, under this section, empowered to ensure smooth implementation of these provisions and to define the areas of research which would qualify for approval. He has developed a set of procedural guidelines for this purpose. The prescribed authority is also the final authority to decide whether, and to what extent, any activity constitutes or constituted, or any asset is or was used for, scientific research.

In respect of expenditures on scientific research, a deduction is allowed in computing the income of a taxpayer depending upon the nature of such expenses. For the purpose of computing the profits and gains of business and professions under section 35(1)(i) of the Act, revenue expenditures incurred for scientific research related to the taxpayer's business is allowed as a full deduction in the year in which such expenditure is incurred. It has also been provided that revenue expenditures incurred by the taxpayer for the payment of salaries to research personnel and on material inputs during the 3-year period immediately preceding the commencement of the business will be regarded as being incurred in the year previous to which the business is commenced. Such expenditure incurred in the pre-commencement period will be allowed as a deduction in computing the taxpayer's income in the year in which the business is commenced. "Salary", for this purpose, will include: wages; annuities or pensions; any fees, commissions, profits in lieu of or in addition to any salaries or wages; advance on salary and annual accretion to the balance to the credit of the employee participating in a recognized provident fund, to the extent it is chargeable to tax under rules of part A of the Fourth Schedule of the Act. However, any expenditure incurred by the employer during the pre-commencement period in providing the following perquisites will not be allowed as a deduction:

(i) residential accommodation to research personnel, free of cost or on a concessional basis;
(ii) any benefit or amenity granted free of cost or at a concessional rate;
(iii) any payment by the employer or any sum in respect of any obligation which, but for such payment, would have been payable by the employee; and
(iv) any payment of any sum, whether directly or through a fund, other than a recognized provident fund or an approved superannuation fund, to affect an assurance on the life of the employee or to affect a contract for an annuity.

To obtain a deduction of pre-commencement expenses, a request has to be made to the prescribed authority with a copy to the Central Board of Direct Taxes (CBDT), Department of Revenue, Ministry of Finance, Government of India, indicating the program of work carried out together with the eligible costs. The CBDT would then issue the necessary certificate containing the extent of permitted expenses on scientific research which would then be allowed a full deduction under the provision.

Section 35(1)(iv) of the Act provides for a deduction in respect of capital expenditures (excluding expenditures incurred after 29 February 1984 on acquisition of land or any interest in land) incurred for scientific research related to the taxpayer's business. All expenditures incurred in any previous year qualify for deduction in that previous year. If the capital expenditure was incurred before the commencement of the business, the aggregate of the expenditure so incurred, within the 3 years immediately preceding the commencement of the business, will be deemed to have been incurred in the year previous to which the business is commenced. No depreciation will be permissible on any capital asset reported as an expenditure allowed as a deduction, whether in the year previous to which such deduction was allowed or in any other prior year.

Eighty-seven percent of the total national expenditure on research and development and science and technology was incurred by the government sector in India and the rest, 13%, by the private sector. Of the total expenditure incurred in 1982-83, 286 million was contributed by the in-house research and development units of the 68 public and 600 private sector industries. Fifty-five percent of the industrial research and development expenditure came from the 470 in-house research and development units of the private sector, and the remaining 45% by 62 public sector undertakings. Fifty percent of the total expenditure by the private sector was for chemicals (other than fertilizers), electrical equipment, industrial machinery, metallurgical industries, drugs, pharmaceuticals and transportation. During 1980-81 the in-house research and development units of the industrial undertakings entered into 320 foreign collaboration agreements,* out of which 87% were with the industrial countries of the West. About 300 million rupees were paid to the foreign collaborators in the form of technical fees, royalties etc., a figures which may not be high when compared with total research and development expenditure in the country. Between 1971 and 1976, India paid nearly 2,000 million rupees in technical fees and royalties in foreign exchange, while the expenditure on research and development was 18,000 million rupees. The ratio, 1:9, compared favorably with advanced industrial countries – 1:10 in Japan and 1:20 in Western Europe. By contrast, in most other countries of the so-called Third World, the expenditure on foreign royalties and technical fees is generally twice or thrice that on home research and development (if there is any home research and development at all).

The Indian Technology Policy Statement recognizes the need to resist the imposition of imported obsolete technology unrelated to India's specific requirements and calls for linkages between research and development units in providing desirable and essential interface between national laboratories and industry. As stated earlier, with this objective in view, fiscal incentives have been provided for forming research and development units in industry.

To commercialize locally developed technology, section 32-A(2B) of the Act allows additional relief to the user of the know-how developed in the country in the form of an investment allowance at a rate of 35%. The machinery and plant eligible for the investment allowance are those installed after 30 June 1977, but before 1 April 1987. The Finance Bill 1985 introduced a further concession to promote local scientific research. The taxpayer can write off the lump sum consideration incurred on acquiring know-how in 3 years (against a general provision of 6 years for acquiring know-how and 14 years for acquiring patent rights or copyrights). The lump sum consideration received by resident scientists for the know-how they developed would be spread (where the development time is more than 12 months) over a period of 3 years and charged accordingly.

To encourage the sustenance and growth of private benevolence for conducting scientific research, approved scientific research associations, universities, colleges or other institutions may benefit from donations made by taxpayers deriving income from business, professions and other sources. Deductible amounts fall within a minimum limit of 250 Rs. and a maximum limit of gross taxable income of 500,000 Rs., whichever is less.

Where a donation is made to an association the sole object of the association must be scientific research, whereas universities, colleges or other institutions must use the sum so donated for scientific research. Under section 35(1)(ii) of the Act, donations made to such bodies are fully exempt in the hands of the donor.

* For more information on collaboration agreements see "Collaboration Agreements – Some Issues" by M.B. Rao in 39 *Bulletin for International Fiscal Documentation* 400 (1985).

Further, under section 10(21) of the Act the income of such scientific research association, which is solely applied to the purposes of that association, is also exempt if the following conditions are fulfilled:

1. investments or deposits must be made in one or more of the specified forms or modes; and
2. shares, if any, must be held only in government companies or statutory corporations.

With effect from 1 April 1980, under section 80 GGA of the Act, the above provision is also applicable to donations made by taxpayers other than those deriving income from a business or profession. The advantage of a donation under this section is that the full amount of the donation is deductible, as no minimum amounts apply.

Under either section 35(1)(ii) or 80 GGA of the Act, once a deduction is claimed and allowed for any assessment year in respect of any payments, a deduction shall not be allowed in respect of such payments under any other provision of the Act for the same or any other assessment year.

The national laboratories and approved institutions can, thus, take advantage of sponsored research by taxpayers and utilize the vast resources available to them for the country's good. Under the Act, gross royalties and premiums earned by the National Research Development Corporation have increased from 8 million rupees in 1980-81 to more than 105 million rupees in 1982-83.

A provision for weighted deduction under sub-section 2A and 2B of section 35 of the Act was deleted by the Finance Act 1984 because of the "experience that an expenditure linked concession for weighted deduction leads to a tendency to inflate expenditure and with a view to simplify the tax laws". The concession under sub-section 2A was linked to the donation by the donor and so is different from the concession under sub-section 2B, which is, in fact, linked to the expenditure in the hands of the taxpayer. In view of this, it is submitted that the amendment to sub-section 2A was not justified, and needs to be restored.

To encourage business to support social science or statistical research in approved universities, colleges or institutions, section 35(1)(iii) of the Act provides for a deduction from the profits and gains of a business or profession and, in respect of other incomes, any sum paid by a taxpayer to a university, college, or other institution approved by the prescribed authority to be used for research related to the class of business of such taxpayer.

Expenditures on research and development by the private sector increased from 75 million rupees in 1978-79 to 1,040 million rupees in 1980-81. Forty percent of the total research and development units in this sector were located in the state of Maharashtra, which incurred about 50% of the total expenditure. This compares favorably with Bombay's contribution to total income tax budget collection of about 23%. Thus, incentives provided in the Act are proving a great stimulus to promotion and encouragement of research and development in India. However, despite lavish fiscal concessions by the government, private research and development expenditure in India has been low. By comparison, although the population of South Korea in 1982 was one eighteenth that of India's and industrial output was US$ 29 billion and 47.5 billion respectively, expenditure on research and development in 1981 and 1982 in India amounted to $ 138.5 million and $ 166.3 million respectively as compared to $ 236.9 million and $ 383.9 million in South Korea. As the Japanese experience shows, to modernize the country India requires not only massive imports of technology but its successful adaptation. This, in turn, requires a considerable amount of expenditure on research and development. It is up to the private sector to accept the challenge.

THAILAND:

Highlights of Changes in the Tax Laws

Information supplied by Mr. Montri Hongskrailers, Coopers & Lybrand Associates, Bangkok

INTRODUCTION

On 31 January 1986, the Ministry of Finance issued an Emergency Decree No. 14 in which various revisions in the Revenue Code were announced. Among the changes were amendments to the taxation of personal income, business income, and corporate income as well as the introduction of a tax amnesty. A survey of the highlights of the tax package follows.

GENERAL PROVISION: PROCEDURE

If the Revenue Department's summons, notifications for tax payments or other communications cannot be sent to the taxpayers because:
(1) the taxpayer has left his domicile and his whereabouts have become unknown; or
(2) the taxpayer has left the country,
the Revenue Officer can post the summons, notifications, or letters at the address most recently listed for the taxpayer's office or residence in government records or he can advertise in the local newspaper; the taxpayer is then deemed to have received the communication.

PERSONAL INCOME TAX

(1) The profit from the sale of debentures of public companies or of companies registered with the Securities Exchange of Thailand is to be taxed in the same

way as profits from the sale of shares or bonds or from the transfer of partnerships.

(2) Tax exemption is provided for the following interest earned:
(a) interest from savings sweepstakes and interest on government time savings deposits on which the interest rate is 8.5% per year;
(b) interest on government fixed savings deposits of not more than 6 months duration on which the interest earned is 10% per year, but only the portion of interest of 8.5% is exempt from taxation;
(c) interest on deposits with banks in Thailand if the interest is 8.5% per year;
(d) interest on deposits with co-operatives;
(e) interest on government bonds which are at 10.5% per year, is now exempt only to the extent of 8.5% per year;
(f) interest from the Government Housing Bank deposits which are 10.75 of 11% per year but only the portion of 8.5% per year is exempt.

(3) Although previously tax-exempt, trading in the following securities will henceforth be taxed:
(a) debentures and non-government bonds;
(b) government bonds, to the extent of any profit in excess of 8% per year.

(4) A distribution of profits by an ordinary partnership or by a non-juristic group of persons to a partner or member, which was formerly totally exempt, shall now be exempt only if the profit is taxable to the partnership or non-juristic group of persons.

(5) Changes in deductions or allowances:
(a) interest on loans made by a bank, a finance company, a finance and securities company, a "credit foncier" company, a co-operative, an insurance company or an employer used to make a purchase or a hire-purchase, or to build a dwelling house were the house is mortgaged with the lender to serve as security for loan repayments, shall be deductible on the portion that is actually paid up to 7,000 baht;
(b) in the case of a husband and wife divorced during a tax year, each spouse is now allowed to deduct only 3,000 baht per child per year. Spouses whose marital status continues throughout the tax year are given an allowance of 5,000 baht.

(6) Tax credits:
The tax credit on dividends received by an individual from a company registered under Thai law is reduced from 35% to 30%.

(7) Rates:
(a) Interest tax rate:
The rate of tax on interest from loans, including government bonds, is increased from 12.5% to 15%, effective from 1 January 1986.
(b) Personal tax rate:
The rates of personal income tax are reduced from 7% on net income of 30,000 baht to 7% on net income of 40,000 baht and from 65% to 55% on net income over 2,000,000 baht, effective from 1 January 1986.

CORPORATE TAX

(1) Dividends generated from securities held by a corporate shareholder shall be exempt from tax if the company holds the securities for at least 3 months before a dividend is received and for 3 months after the dividend is received (a total of at least 6 months).

(2) The corporate income tax rates are reduced by 5% from the previous rates, as follows:

	New rate
For companies registered with the Securities Exchange of Thailand	30%
For other companies	35%

(3) The income tax rate for foundations or associations which are not exempt from tax is increased from 5% to 10% of gross receipts from goodwill, copyright or other rights; interest, dividends, rental of property, and professional fees. However, on gross receipts from commerce, industry, and transportation, the tax is reduced from 5% to 2%.

BUSINESS TAX

(1) Revision of the definition of gross receipts is made in the tape rental business to cover deposit money, membership fees, fees for the hire of services for recording tape, sales of recorded tape, in addition to amounts received from rents.

(2) Revision of the definition of gross receipt for the rental of property is made to include any money, property, remuneration, or other benefits received on that portion which are higher than the cost to the taxpayer.

(3) The assessment officer is given the power to fix the minimum gross receipts on which the trader shall be taxed.

(4) The tax rate is increased from 40% to 50% of gross receipts on imported cars or 10-seat buses with diesel engines and the tax rate is reduced from 40% to 30% of gross receipts for cars and buses produced locally.

(5) The import of machinery, component parts, and accessories to be used by the importer in his own production, which was previously tax exempt, is now taxed at the rate of 5% of gross receipts.

(6) The diesel engine tax is increased from 5% to 9% except for diesel engines for fishing boats on which the tax remains unchanged.

STAMP DUTY

(1) The stamp duty on loans or bank overdraft agreements which was formerly to be affixed at the rate of 1 baht for every 2,000 baht on loans or bank overdraft agreements without any ceiling, shall now be affixed at the same rate but with a ceiling of up to 10,000 baht.

(2) The stamp duty previously affixed to all government forms is repealed.

TAX AMNESTY

A taxpayer, who has not yet paid tax or who has paid tax incorrectly, may, on application, be exempt from a tax audit, assessment, or any order for tax payment (including criminal charges) on income or gross receipts earned before or during the 1984 tax year. The tax amnesty is granted on the following conditions:

(1) the taxpayer must file an application, as prescribed by the Director General of the Revenue Department, *before* July 1986;

(2) the taxpayer must pay the tax due (as computed by the rules set out below) within the time and on the conditions to be prescribed by the Director General.

The computation of the tax due is to be as follows:

(1) At the rate of 3% on the value of all assets minus the value of all debts as of 31 December 1984 or the last date of the 1984 accounting year.
(2) The following rates are applicable on gross receipt:
- 1.5% on gross receipt up to 100 million baht;
- 1.0% on that portion of gross receipt exceeding 100 million bath;
- 0.5% on that portion of gross receipt exceeding 500 million baht.

The gross receipt means the assessable gross receipts or the gross receipts before the deduction of any expenses as averaged on the years the taxpayer has had income but for not more than 5 years from the tax year or accounting year ending on or before 31 December 1984.

This amnesty shall not cover:

(1) companies which according to law do not pay tax on a net profit basis, e.g., airlines or maritime companies, associations, or foundations;

(2) taxpayers (individual and juristic persons) who were assessed or ordered to pay or to remit tax by an assessment officer for income or receipts earned before 1984 or the 1984 accounting year end, on the portion so assessed.

INDONESIA:

Overhaul of an Inherited Tax System
New tax on land, buildings and new stamp duties

By Jap Kim Siong

A. INTRODUCTION

The second phase of the tax reform in Indonesia, to overhaul the tax system inherited from the former Netherlands East Indies Government, began on 1 January 1986.

The first phase, to establish its own national tax system, started on 1 January 1984 by the introduction of the 1984 Income Tax Act (*Pajak Penghasilan*), which replaced the Corporate Income Tax Act 1925 (*Pajak Perseroan*), the Individual Income Tax Act 1944 (*Pajak Pendapatan*) and the Tax on Interest, Dividends and Royalties Act 1970.[1] The Sales Tax Act 1951 was replaced by a value added tax on goods and services and a sales tax on luxury goods on 1 April 1985.

The laws concerning the taxation of land, buildings and stamp duties were enacted on 27 December 1985 and took effect on 1 January 1986.

The Tax on Land and Buildings Law (*Pajak Bumi dan Bangunan*) replaced the Net Wealth Tax Act 1932 (*Vermogensbelasting* or *Pajak Kekayaan*), the Household Tax Act 1908 (*Personele belasting* or *Pajak Rumah Ranggah*), the Road Tax Act 1942 (*Weggeld 1942*), the Local Land Yield Tax Act, i.e. the *Verponding* 1928 and *Verponding* Indonesia 1923 (*Inlandsche Verponding*) and the Contribution for Regional Development (*Iuran Pembangunan Daerah or IPEDA*) which is levied on land and buildings. IPEDA, a national tax, was levied on individuals and entities who owned title to land or buildings. The tax base and tax rates differed, depending on the valuation schemes (e.g. rural, urban, forestry, mining or plantations).

The net wealth tax was a national tax and the household tax was a local tax, both levied on properties owned by individuals only.

The revenue from the tax on land and buildings is estimated to amount to 284,000,000,000 Indonesian Rupiahs (Rp)[2] in financial year 1986/87, beginning 1 April 1986. Ninety percent of the total revenue derived from the tax on land and buildings is for the local government, and 10% for the national government. The national government collects the tax. Revenue from IPEDA was 170,000 million Rp; from net wealth tax, 40,000 million Rp; and 7,000 million Rp from household tax.

1. Jap Kim Siong, The Three Tax Reform Laws in 38 *Bulletin for international fiscal documentation* 130-134 (1984).
2. One US$ is equivalent to about 1,100 Rp.

The Stamp Duties Law No. 13 of 1985 replaced the Stamp Duties Ordinance 1921 (Zegelverordening 1921) as from 1 January 1986.

The goal of the two new tax laws is to simplify and reduce the taxpayers tax burden as compared to the former taxes. The new stamp duties law comprises only two stamp duties of 500 Rp and 1,000 Rp, contained in a law of 18 clauses. This is in contrast to the 167 duties in 142 clauses previously applied. The former stamp duty on corporate rights, levied at the rate of 0.1% on the paid-up capital of the issued share capital of a corporation, is no longer levied under the new stamp duties law. Now only a 1,000 Rp stamp duty must be paid on financial documents having a face value exceeding 1,000,000 Rp.

B. TAX ON LAND AND BUILDINGS (PAJAK BUMI DAN BUNGUNAN OR PBB)

As from 1 January 1986, the Land and Buildings Tax Law No. 12 of 1985 governs the levy of this property tax on all land and buildings situated in Indonesia.

Transition period

Any property subject to tax (net wealth tax, household tax, IPEDA, etc.) under the former tax laws prior to 1 January 1986, will continue to be subject to tax and this tax must be paid before 1 January 1991.

The IPEDA payable under any contract for work or production sharing contract, concluded prior to 1 January 1986 between a foreign company and the Indonesian state-owned company, Pertamina, operating in the field of mining, oil and gas exploitation, remains in force until the contract period has elapsed.

The implementing regulations of IPEDA remain in force until 31 December 1990 if not replaced by new regulations or if not in conflict with the provisions of the Land and Building Tax Law.

Taxpayers

Individuals and entities owning land or buildings or owning rights to use land or buildings are subject to this real property tax. Its taxable base is the deemed fair market sales price estimated by the tax administration.

Tax year

The tax year is the calendar year. The situation on 1 January of each year is relevant in determining the amount of the real property tax. Any change after 1 January will not affect the tax liability of the taxpayer during the calendar year. It is also immaterial whether the taxpayer is a resident or non-resident of Indonesia.

Taxable real property

A "building" is defined as a technical construction which is erected on or permanently attached to land and/or waters of Indonesia. The term "building" includes roads leading to a building complex, structures like hotels, factories and other facilities which form an integral part of the building. Toll roads, luxury gardens, fences, swimming pools, olympic stadiums, quay-walls, and oil refineries are also considered buildings.

The tax administration determines the tax on land and buildings of a taxpayer in accordance with the registered, detailed data available. In the event no data are available, the tax administration may require that the taxpayer files a return within 30 days.

Exemptions

Persons and entities are exempt from the tax on land and buildings when the land or buildings are held for social, educational, cultural, religious and public purposes and not with the goal of deriving profit.

Wilderness, wild life preserve land and government land, not yet having a fixed use, is also exempt from the property tax. The exemption is also applicable to diplomatic persons, consulates and international organizations owning land or buildings. The Minister of Finance is entitled to exempt or reduce the tax on land and buildings payable by taxpayers in the event of flood, crop failure, or other natural disaster.

Taxable base

Land is classified into 50 categories each having its fair market sales price per square meter. Buildings are classified into 5 categories, each category is divided into 4 classes. Special rules apply to the taxable base of land and buildings used for plantations, mining and forestry. The classification of the fair market sales price of land and buildings are determined every 3 years by the Minister of Finance (1003/KMK.04/1985 of 28 December 1985).

In determining the taxable base, the fair market sales price per square meter is multiplied by a percentage determined by the Minister of Finance, which is set between 20% and 100%. For 1986 the said rate is set at 20% (assessment value rate). The taxable base is thus 20% multiplied by the fair market sales price per square meter.

Tax free deduction

The tax free deduction is 2,000,000 Rp for each *building*. No tax free deduction exists for land.

Tax rate of PBB

The rate of the land and building tax is 0.5% of the taxable base.

Example

Assume, the taxpayer owns the following taxable properties:
- land with an area of 800 sq.m., with a fair market sales price of 300,000 Rp/sq.m.; and
- a building with an area of 400 sq.m., with a fair market sales price of 350,000 Rp/sq.m.

The land and building tax is calculated as follows (in Rp):

Sales price of land:	
800 x 300,000	240,000,000
Sales price of building:	
400 x 350,000	140,000,000
Less the tax free deduction	2,000,000
	138,000,000

The total amount of land and building tax is

– on land	
0.5% x 20% x 240,000,000 =	240,000
– on building	
0.5% x 20% x 138,000,000 =	138,000
Total	378,000

Penalties and fines

The administrative fine is 25% from the understated tax (PBB), in case, after an investigation, more tax is found to be payable or no tax return has been filed by the taxpayer after a written request. A taxpayer who has intentionally evaded paying PBB, either by understating his tax or failing to file a return, may be imprisoned for up to one year or be subject to a fine of up to five times the amount of tax evaded. A taxpayer who because of carelessness has not paid the appropriate PBB, may be imprisoned for up to 6 months or be subject to a fine of up to twice the amount of tax not paid. Third persons who have intentionally not shown documents or given information which resulted in a loss in tax revenue, may be imprisoned for up to one year or be subject to a fine of up to 2,000,000 Rp. The penalty is doubled if the same person again evades PBB within one year from the date he was sentenced.

Penalties cannot be imposed retroactively after 10 years beginning from the end of the tax year involved.

C. STAMP DUTIES (BEA METERAI OR BM)

Taxable documents

Stamp duties are imposed on those legal documents and copies which are of a "civil" law nature when they are specified in the Stamp Duties Law No. 13 of 1985. In general, documents executed by the government or its subdivisions are not dutiable, except deeds on land. The following documents are dutiable:
- every contract or letter of agreement executed for use as evidence or proof in a civil law proceeding;
- notarial title deeds and copies thereof;
- documents of title deeds on land executed by the responsible civil servant; and
- financial documents specifying an amount exceeding 1,000,000 Rp such as letter of money receipts, certificates of deposit, vouchers mentioning the balance of bank accounts, bills of exchange, promissory notes, securities having a face value exceeding 1,000,000 Rp, as well as any document to be admitted in Indonesian courts.

A foreign document cannot be used in Indonesia unless it has been duly stamped.

Exemptions

Exempt from stamp duties are: documents in the nature of an acknowledgement for the receipt of goods; bills for the transportation of persons and goods; bills for the storage of goods; certificates attesting the completion of a public school or course, pawnshop bills executed by the State Pawnshop; receipts for dividends and interest payments from shares and bonds; receipts for savings deposits; and receipts from the Treasury, local government or bank for any tax paid.

Payments

Stamp duties are payable by the receivers or holders of documents required to be duly stamped. Stamp duty is considered paid where an adhesive duty stamp is affixed upon the document and duly cancelled.

Stamp duties

The stamp duty for foreign documents to be used in Indonesia is paid to the General Post and Giro Office. The stamp duty rates for financial documents are:

Nominal value in Rp	*Stamp duty in Rp*
100,000 – 1,000,000	500
more than 1,000,000	1,000

The stamp duty is 1,000 Rp for any foreign documents to be used in Indonesia and for all non-financial documents specified in the Stamp Duties Law as requiring a stamp.

Penalties and fines

The persons responsible for documents that must be duly stamped under the Stamp Duty Law, when the stamp duty is not fully paid, will be punished by an administrative fine amounting to 200% of the stamp duty amount not paid.

Liability for payment of the stamp duty expires after 5 years, beginning from the date the document has been executed.

GHANA:

Tax Incentives for Investment

Ghana's more realistic approach

By Servaas van Thiel

In 1985 Ghana introduced a new Investment Code and repealed the 1981 version. This article will discuss whether this new code is an improvement and to what extent the newly proposed use of investment incentives by Ghana may be a model for other Western African countries.

Part I gives a description of the 1985 Ghana Investment Code. After a short introduction, an outline is provided of the restrictions and priorities and of the application and approval procedures followed by a brief description of beneficiaries and investment incentives.

Part II provides a description of the major changes in the 1985 Code and an evaluation of Ghana's choices against the background of the general literature on the use of investment incentives for development.

I. NEW INVESTMENT CODE

A. Introduction

Ghana has a positive attitude towards foreign private investment, but opposes foreign domination of certain sectors of its economy.

Therefore, the investment legislation, on the one hand, prescribes local participation requirements in certain enterprises and, on the other hand, provides for protection and investment incentives.

The main investment legislation includes the Investment Code 1985[1] and the Petroleum (Exploration and Production) Law 1983.[2] Mining activities remain outside the scope of both laws and a new Minerals Code is still under consideration. Also, a separate law applies to investments in the energy sector.

The Investment Code 1985, which replaces the 1981 version, is administered by the Ghana Investments Centre (hereinafter the Centre) which is governed by a Board consisting of persons with sound knowledge or experience in investment matters. The Centre's main tasks include the collection and dissemination of investment-related information, the identification of projects, the registration and approval of investments and technology transfer contracts, and the granting of priority status and incentives. In addition, the Centre maintains a liaison between investors and public authorities and recommends changes in investment-related legislation.

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The main body in the petroleum sector is the Ghana National Petroleum Corporation (hereinafter the Corporation) which was established in 1983. The corporation is governed by a Board of Directors consisting of qualified persons from the public sector. The corporation has the exclusive right to engage in the exploration, development and production of petroleum. It can do so with the assistance of contractors subject to the provisions of a petroleum agreement as concluded between the contractor, the Corporation and the Government of Ghana.

B. Restrictions and priority areas

The following enterprises are reserved for Ghanaians:

(a) any enterprise concerned with retail or wholesale trade, unless such business is carried on by or within a department store or a supermarket which has an employed capital of not less than US$500,000;

(b) the sale of anything whatsoever in any market, petty trading, hawking, or selling from a kiosk at any place;

(c) business representation for foreign companies, unless the enterprise has an employed capital of not less than US$500,000 or its equivalent;

(d) operation of a taxi service or a car hire service;

(e) the sale under a hire-purchase contract of motor vehicles, including vehicles intended to be used in the operation of a taxi or a car hire service;

(f) produce brokerage, unless the employed capital of the enterprise is not less than US$500,000;

(g) advertising agencies and public relations businesses;

(h) all aspects of the pool betting business and lotteries;

(i) estate agencies;

(j) travel agencies;

(k) lighterage services;

(l) commercial transportation of passengers by land;

(m) bakeries;

1. Investment Code, Act 437, 1981 was replaced by Investment Code, P.N.D.C.K. 116, 1985.
2. Petroleum (Exploration and Production) Law, P.N.D.C.L. 68, (1983).

(n) the manufacture of articles from foam materials;
(o) operation of beauty salons and barber shops;
(p) the manufacture of cement blocks for sale;
(q) the manufacture or tailoring of garments, other than for export;
(r) textile screen hand printing (including tie and dye);
(s) tire retreading;
(t) manufacture of suitcases, briefcases, portfolios, handbags, shopping bags, purses and wallets, other than for export.

All other enterprises are eligible for foreign participation provided that the foreign investment equals at least US$60,000 in the case of a joint venture with a Ghanaian partner, or US$100,000 in the case of a wholly foreign-owned enterprise.

Enterprises which are wholly foreign-owned, however, can only be approved by the Centre, e.g. enjoy the benefits of the Investment Code 1985, if they are net foreign exchange earners.

The possibilities of foreign investment in the petroleum sector are restricted to contractual arrangements for the exploration and sale of petroleum by the corporation. Any foreign oil company that has negotiated a petroleum agreement is obliged to establish a subsidiary in Ghana incorporated under the Companies Code 1963.[3]

The Investment Code 1985 mentions the following priorities:

a. Agriculture:
(i) production, protection, processing, and preservation of crops and livestock;
(ii) any other agricultural activities, including services, as may from time to time be prescribed.

b. Construction and building industries:
(i) real estate development;
(ii) road construction;
(iii) any other activity in the construction and building industries, as may from time to time be prescribed.

c. Manufacturing industries:
(i) manufacturing for export;
(ii) manufacturing industries that predominantly use local raw materials;
(iii) manufacturing industries that produce agricultural equipment, machinery, spare parts, and machine tools.

d. Tourism:
Enterprises concerned with the development of the tourist industry such as tourist accommodation, insofar as these are net foreign exchange earners.

The Centre may, from time to time, specify priority sectors or geographical areas.

C. Application and approval procedures

The following procedures are relevant for investors:

(a) Ghana has established a general system of industrial licensing under the Manufacturing Industries Act 1971.[4] Everyone establishing or expanding a manufacturing industry must apply for a license from the Minister for Industry. The Minister may grant or refuse a license and may set terms and conditions as he sees fit. The criteria used in this decision concern the location, size, type, and viability of the enterprise as well as the use of local resources.

Without a valid license an investor will not be able to obtain import or export licenses, immigration quota, or any other concession. The Minister of Industry may, after consultation with the Ghana Investments Centre, exempt a person or industry from the license requirement and a license will be issued automatically to a manufacturing enterprise which is already approved by the Ghana Investment Centre.

(b) Any enterprise, other than a manufacturing enterprise, is required to obtain an establishment license from the competent public authority.

(c) In order to qualify for the benefits under the Investment Code 1985, an investor should apply for approval to the Ghana Investments Centre. Extensive information on the project and the applicant must be disclosed. Application forms can be obtained from the Centre. Upon receipt of an application, the Centre will submit the form to competent authorities within 14 days. Comments or observations must be returned to the Centre within 21 days.

Important criteria in granting approval are the following:
(i) development of the productive sectors of the national economy;
(ii) efficient utilization, expansion, and diversification of the productive capacity of existing enterprises;
(iii) utilization of local materials, supplies, and services;
(iv) the creation of employment opportunities in Ghana;
(v) real increases in national export earnings;
(vi) real savings on national imports;
(vii) development and transfer of advanced technology, incuding the upgrading of indigenous technology;
(viii) country-wide distribution of viable enterprises;
(ix) the need to generate constructive competition and to avoid monopolies;
(x) environmental effects;
(xi) the location of the enterprise;
(xii) such other criteria as the Centre may consider relevant for achieving the objectives of the Code.

In granting approval, the Centre may specify conditions concerning the amount and source of capital, the nationality and number of shareholders, the project

3. The Companies Code 1963, Act 1979, as amended by Act 421 (1980). The Ghana Company Law differs in certain respects from the company law of most other Anglophone African countries. Firstly, there is a minimum capital requirement of 5,000 Cedis. Secondly, annual dividend payments are restricted by a special formula which seeks to protect the companies' creditors. Thirdly a company is not allowed to buy the shares of its holding company. Finally, certain directors' decisions, including the disposal of a substantial part of the assets, the issue of new shares to third parties, and contributions to charitable funds, require prior approval of the general meeting of shareholders.
4. The Manufacturing Industries Act 356, 1971.

size, the training of Ghanaians, the commencement of the project reporting requirements, environmental protection, the utilization of local resources, and other matters having regard to the objectives of the Investment Code.

Upon approval, the Centre will issue a certificate of approval. The certificate is deemed to be a manufacturing license or an establishment license.

(d) "Technology Transfer Agreement" means any agreement with a duration exceeding 18 months and relating to an enterprise approved under the Code involving:
(i) the assignment, sale and use of foreign patents, trademarks or other industrial property rights;
(ii) the supply of foreign technical know-how or technological knowledge;
(iii) foreign technical assistance, design and engineering consultancy or other technical services in whatever form they may be supplied;
(iv) foreign managerial, marketing or other services.

All existing technology transfer agreements must be submitted to the Centre within 6 months, i.e. before 13 January 1986. The Centre may advise the parties on the suitability of the technology and on the level of remuneration.

The renewal of existing agreements and the conclusion of new technology transfer agreements is subject to approval by the Centre. The agreements cannot come into effect without such approval.

(e) The Centre may designate approved enterprises located in specific geographical areas or active in certain economic sectors, as priority enterprises. Special incentives are available for priority enterprises (see 1.E., below).

(f) Any person who intends to negotiate an agreement for the exploration, development or production of petroleum must submit an application to the Provisional National Defence Council Secretary for Fuel and Power.

Specific regulations and competitive bidding procedures may be prescribed. The petroleum agreement is concluded with the Corporation and the Government and has a maximum duration of 25 years. It cannot be assigned to another person without prior approval of the Secretary. The terms of the agreement contain minimum work and expenditure requirements, a rebus sic stantibus clause, an option for the corporation to buy interests in successful petroleum operations, clauses to pay income tax and royalties, etc.

D. Investors eligible for incentives

All investors approved by the Centre are eligible for the general benefits. All investors in priority sectors or areas are eligible for specific incentives. Finally, additional incentives are granted to certain approved investors.

E. Investment incentives

The Investment Code 1985 provides for (a) general incentives for all approved investors, (b) specific incentives for some approved investors, and (c) specific incentives for priority investors.

(a) The general incentives for all approved investors include the following:
(i) the investor is deemed to have obtained a manufacturing or establishment license;
(ii) immigrant quota will be granted in respect of the approved number of expatriate personnel;
(iii) personal remittance quota for expatriate personnel is exempt from any tax imposed by any enactment on the transfer of external currency out of Ghana;
(iv) exemption from Selective Alien Employment Tax under the Selective Employment Tax Decree 1973;[5]
(v) free transferability, through the Bank of Ghana or, in the case of a net foreign exchange earning enterprise, through the external account opened with the permission of the Bank of Ghana, in freely convertible currency of:
  - dividends or net profits attributable to the investment of such freely convertible currency;
  - payments in respect of loan servicing where a foreign loan has been obtained by an approved enterprise;
  - fees and charges in respect of any technology transfer agreement approved under this Code;
  - the remittance of foreign capital in the event of a sale or liquidation of the approved enterprise or any interest in the approved enterprise attributable to foreign investment;
(vi) a non-expropriation guarantee;
(vii) a deferment of payment of stamp duty, granted by the Board for a period not exceeding 5 years where it is satisfied that the circumstances prevailing at the time of the application for the benefit justify such deferment.

(b) The specific incentives for some approved investors include the following:
(i) a reduction or deferment of income tax payable to enterprises located in areas lacking in basic infrastructure where the enterprise undertakes the costs of such infrastructure;
(ii) an enterprise which utilizes Ghanaian labour in preference to imported machinery is entitled to an income tax rebate as follows:
  - in the case of agriculture, where an enterprise employs more than 20 Ghanaians, the value of the Social Security contribution payable in respect of every Ghanaian employee in excess of the first 20;
  - in the case of manufacturing industries, where an enterprise employs more than 100 Ghanaians, the value of the Social Security contribution payable in respect of every Ghanaian employee in excess of the first 100;
  - in the case of construction and building industries, where an enterprise employs more than 75 Ghanaians, the value of the Social Security

5. National Redemption Council Decree 201, 1973.

contribution payable in respect of every Ghanaian employee in excess of the first 75;

(iii) all foreign exchange earning enterprises may be permitted by the Bank of Ghana to retain, in an external account under the supervision of the Bank of Ghana, a portion of their foreign exchange earnings for use in acquiring spare parts and other inputs which would otherwise not be readily available without the use of such earnings. In the case of a net foreign exchange earning enterprise, the Bank of Ghana permits the operation of an external account in which at least 25% of the foreign exchange earnings may be retained in order to acquire machinery and equipment, spare parts and raw materials as well as to service debts and to provide for profit and dividend payments and remittances in respect of quotas for expatriate personnel.

(c) Hereafter, is a list of the specific incentives available for investors in priority sectors and regions.

For priority investors in the *agricultural sector* the following incentives are available:

(i) government guarantee of land used for the establishment and operation of the project;
(ii) requisite permission for importing essential plant, machinery, equipment, and accessories required for the enterprise;
(iii) exemption from payment of customs import duties on plant, machinery, equipment, and accessories imported specifically and exclusively to establish the enterprise once approved;
(iv) a corporate income tax rate of 45% with the following allowances and deductions:
  - depreciation or capital allowance on plant, machinery, equipment and accessories to the extent of 100% in the year of investment;
  - investment allowance of 10%;
  - in the case of tree crops and livestock, excluding poultry, an income tax rebate over a three-year period to be specified by the Centre at the following rates:
    75% in the first year;
    50% in the second year; and
    25% in the third year.
  - exemption of staff from payment of income tax relating to furnished accommodation on the farm.

For priority investors in the *manufacturing industries,* the following incentives are available:

(i) requisite permission for importing essential machinery and equipment required for the enterprise;
(ii) exemption from the payment of customs import duties in respect of plant, machinery, equipment, and accessories imported specifically and exclusively to establish the enterprise once approved;
(iii) investment allowance of 7.5%;
(iv) depreciation or capital allowances of 40% in the year of investment and 20% in subsequent years.

For investors in the *construction sector* the following incentives are available:

(i) requisite permission for importing essential machinery and equipment required for the enterprise;
(ii) exemption from the payment of customs import duties on plant, machinery, equipment, and accessories (excluding building materials), imported specifically and exclusively to establish the approved enterprise;
(iii) investment allowance of 7.5% per annum;
(iv) exemption of staff from income tax relating to accommodation provided on building or construction site;
(v) depreciation or capital allowances of 50% in the year of investment and 25% in subsequent years.

For investors in *tourism* the following incentives are available:

(i) exemption from customs import duties on plant, machinery, equipment, and accessories, imported specifically and exclusively to establish the approved enterprise;
(ii) depreciation or capital allowance as follows:
  (a) plant and machinery: 50% in the year of investment and 25% in subsequent years;
  (b) buildings: 20% in the year of investment and 10% in subsequent years;
(iii) exemption from taxes and rates levied on building properties for a period not exceeding 3 years;
(iv) investment allowance of 7.5%" per annum" (sic).

For investors in *certain regions* a reduction of company tax is available in the following manner:

(i) enterprises situated within Kumasi and Sekondi-Takoradi Metropolitan areas, a reduction of 15% on the company income tax payable;
(ii) enterprises situated within regional capitals other than Accra-Tema Metropolitan area, Kumasi, Sekondi-Takoradi, and Wa, a reduction of 25% on the company income tax payable;
(iii) enterprises situated in the rest of the country including Wa, but excluding Accra-Tema Metropolitan area, a reduction of 40% on the company income tax payable.

In addition to the benefits and incentives mentioned above, where *any enterprise with priority status* undertakes or supports a program of scientific research in Ghana, approved by the Centre, for the purpose of developing or advancing the said enterprise, the capital expenditure in respect of such research shall be fully deductible.

II. APPRAISAL OF THE CHANGES

A. Comparison

The main differences between the 1981 and 1985 Investment Codes concern local participation requirements, the definition of priorities, the application procedures, and the incentives offered.

The 1985 Code maintains or relaxes the local participation requirements.

Firstly, the list of enterprises wholly reserved for Ghanaians has not been extended, but for the fact that foreign participation in retail or wholesale trade, business representations, and produce brokerage is made more difficult by raising the minimum foreign capital requirement from Cedi 2 million (approximately $40,000 – November 1985 exchange rate) to $500,000.

Secondly, the 1981 list of enterprises in which a 40% or 60% Ghanaian participation was compulsory is replaced by the general allowance of foreign investment in all enterprises not exclusively reserved for Ghanaians, provided the foreign investment equals at least $60,000 in a joint venture and $100,000 in a wholly foreign owned enterprise.

Thirdly, though taken out of the Investment Code, the limitation of foreign investment in the petroleum sector to contractual arrangements was sustained.

The definition of priorities is almost the same in both versions of the Investment Law, with the following exceptions. The priority of the export-oriented sector is strengthened by removing the conditions of a 50% Ghanaian resource input and a 75% export requirement of total output. In the construction sector, priority shifted from the production of building materials to the development of real estate and the construction of roads.

An important change in the application and approval procedures is the introduction of deadlines. Theoretically, applicants could from now on be informed of the decision within 5 weeks of filing the application. The criteria for approval are roughly the same in both versions of the Investment Code, but the conditions which may be attached to the approval by the Ghana Investment Centre are broadened, and the grip of the Centre on technology contracts is tightened.

As to the package of incentives granted, there are substantial differences.

1. The automatic 5-year exemption from customs duties on machinery, equipment, and accessories for the establishment of all approved enterprises has been replaced by an exemption of customs duties on plant, machinery, equipment, and accessories specifically and exclusively to establish enterprises in one of the priority sectors. The 3-year exemption from customs duties on spare parts and other imports apart from raw materials which was available to all approved enterprises has been abolished entirely.

2. The 4-year 20% deduction from personal income tax of capital expenditure incurred by individuals on scientific research concerning the development of approved enterprises was replaced by a possible full deduction of such costs by priority enterprises in case of research programs approved by the Ghana Investments Centre.

3. A new general incentive was introduced in the form of a possible deferred payment of stamp duty (maximum 5 years) to be granted at the discretion of the Ghana Investments Centre.

4. The discretion of the Centre to grant capital allowances at rates additional to the rates provided in the 1975 Income Tax Decree to all approved enterprises was repealed. Instead, generous capital and investment allowances are being granted to priority projects.

5. The discretion of the Centre to grant tax holidays and customs duty drawbacks to export enterprises has been repealed. Only the right of exporters to retain part of their foreign exchange earnings in a special account in order to meet import requirements, to service debts or to provide for remittances of quota for expatriate personnel or dividends has been retained. The definition of export enterprises has been broadened. The 50% local input and 75% export requirement was replaced by the requirement of being a net foreign exchange earner.

6. The regional incentive schemes have also been amended to the effect that the Centre can no longer grant overall tax holidays and remittances of customs duties paid. The reductions of corporate income tax up to 40% for enterprises located outside the Accra-Tema metropolitan area has been retained.

7. In the sectoral incentive schemes (agriculture, construction, manufacturing and tourism) the possible tax holidays were replaced by fixed capital and investment allowances. Additional income tax rebates are available only to priority agricultural enterprises and an extra exemption from tax on real estate (maximum 3 years) is available only to priority enterprises in the tourist sector.

B. Comments

The relaxation of the local participation requirements indicates a pragmatic approach towards the dual objectives of attracting private investment for development and increasing local participation in the economy.

The reservation of mostly small economic activities to Ghanaians is realistic, particularly because the concept "Ghanaian" is linked to citizenship rather than to nationality, thereby including the Lebanese communities which traditionally have played an important role in small and medium business in Western Africa.[6] The repeal of the 40% and 60% Ghanaian participation requirement for banking and insurance as well as the compulsory local participation requirement for a large number of commercial and industrial enterprises is welcome, as it removes a rather artificial barrier to foreign investment. Firstly, the banking and insurance participations were unrealistically high. Secondly, as the local participations in other businesses theoretically could be as low as 1 share, it did not effectively serve the objective of a greater local participation in the economy, but imposed an extra requirement for the foreign investor. Leaving the choice to the investor

6. The same pragmatic approach is not followed in all West African countries. The 1984 Guinean Investment Code defines Guinean nationals as those persons who have a Guinean mother or father with Guinean ascendants for 3 generations.

while making the joint venture more attractive is a much more realistic policy. If the foreign investor finds himself an appropriate partner, he will definitely take advantage of a linkage to the community in which he is doing business. Moreover, he will be automatically eligible for approval and, thus, for the benefits of the Investment Code. If he does not find a partner, he nevertheless will be able to continue with the investment, provided he is willing to increase the initial amount and, if he is a net foreign exchange earner, he will be eligible for the benefits of the Investment Code. This, in fact, makes it more difficult, although not impossible, for non-net foreign exchange earning foreign investors to establish a wholly-owned business.

The introduction of deadlines in the application and approval procedures is a good reaction to the general complaint by investors concerning the bureaucracy in developing countries. In this respect, it is also positive that the Ghana Investment Centre is the only government agency that deals with investors and that it provides all necessary stamps and approvals. It is a bit awkward, however, that no deadlines are set for the Centre's final decision on the application.[7] The extension of the Centre's powers to attach conditions to the approval of investments and technology contracts may provide a useful instrument to optimize the investor's contribution to economic development priorities and to minimize the possible misuse of their international character.[8] On the other hand, the increased discretion of the Centre may also be used for undue advantages and this is a concrete problem in many developing countries.

First, some of the changes in the incentive package will be discussed individually. Thereafter, some general remarks will be made on the package as a whole.[9]

1. The reduced importance of tariff concessions is a positive step. Though these concessions are thought to be powerful incentives,[10] they are costly in terms of revenue foregone. They also distort the optimal allocation of resources and discourage local production of the imported products. Moreover, they tend to favor capital-intensive over labor-intensive ways of production, which is not preferable in a labor-surplus economy. Finally, the use of custom tariffs as an instrument of national investment policy hinders the establishment of a common customs tariff in the framework of ECOWAS.[11] The creation of such a common tariff and the resulting enlargement of the market is in itself an important factor influencing investment in the region.

2. The replacement of the deduction, for purposes of individual income tax for research costs, by a full corporate deduction seems logical because companies rather than individuals may be expected to be the agents of industrial research and technical innovation.

3. The granting of generous capital and investment allowances to priority projects in all economic sectors is positive. Generous depreciation allowances reduce tax liability in the short run (not overall tax liability) thus increasing a person's capital expenditure or reinvestment potential. In comparison with other incentive devices such as an overall tax holiday and cash grants they are less costly since they defer rather than reduce tax liability.

An initial investment allowance allows the immediate deduction of part of the capital expenditure without reducing the book value of the asset concerned. It allows a total deduction in excess of the real cost of the asset and therefore amounts to a gift equalling the percentage of the allowance times the cost of the asset times the applicable tax rate. It increases a person's investment potential, but, assuming equal rates, is more costly than accelerated depreciation, although generally not as costly as a tax holiday.

4. The elimination of the possibility to grant tax holidays is also a positive development. The cost of the incentive is the revenue foregone, but this is only a cost if the investment would have also been undertaken without the incentive measure. This is difficult to establish, but generally it can be said that a tax holiday is only without cost where it tips the balance for marginal investments which would not otherwise have been

7. Arts. 25 and 26.

8. International corporate structures may shift their profits to low tax areas. OECD "Transfer pricing and multinational enterprises", 1979, Paris. OECD "World economic interdependence and the evolving north south relationship", 1983, Paris.

9. See for general discussion on tax incentives in developing countries the following studies:
- J. Heller, K. Kauffman, *Tax incentives for industry in LDC* (1963). This study discusses the effects of income tax incentives in developing countries and quotes earlier studies on Puerto Rico (1957, Madison), Mexico (1959, Ross and Christensen), Ghana (1958, Smith; 1958, Perry) and Philippines (1963, Heller, Kauffman).
- Lent 1967 (see footnote 10). This study discusses the desirability of tax incentives and quotes the above-mentioned study and studies on Israel (1966, Ilan), Jamaica (1966, Chen Young), Nigeria (1962, Lewis; 1966, Aluka) and Taiwan (1966, Shun-hsin Chou).
- Toye, *Taxation and economic development, 12 critical studies* (1978). This study discusses attempts made to measure the impact of tax incentives and argues that justifications of the use of incentives are dubious. In addition to the above-mentioned studies, it quotes country studies on Brazil (1972, Goodman), Colombia (1972, Billsborrow, Porter), Ecuador (1969, Tanzi), Malaysia (1977, Kazunaratne, Abdullah), Mexico (1972, Katz), Nigeria (1976, Olaloku) and Pakistan (1969, Hussain; 1973, Ahmad; 1974, Hamid, Hussain; 1974, Azahr, Sharif).
- Galenson, *Investment incentives for industry: some guidelines for developing countries* (1984). This study, published by the World Bank, discusses incentive systems with special reference to African countries. In addition to the above-mentioned country surveys it quotes studies on Ghana (1978, Ingram, Pearson), Puerto Rico (1957, Taylor; 1981, Bond), Philippines (Bantista, 1979) and Sudan (1979, Acharya). It also quotes studies which have attempted to investigate the impact of incentives on investors (1961, Robinson; 1955, Barlow, Wender; 1980, Frank; 1983, Guisinger).

The following evaluation of incentive techniques is based on the literature mentioned in footnote 9 and on the more general public finance literature including the following standard works: R.A. Musgrave, *Public Finance in theory and in practice* (3rd ed. 1980); J.F. Due and A.F. Friedländer, *Government finance, economics of the public sector* (5th ed. 1973); S. James and C. Nobes, *The economics of taxation* (1980); B.P. Herber, *Modern public finance, the study of public sector economics* (3rd ed. 1975).

10. G.E. Lent "Tax incentives for investment in developing countries", I.M.F. Staffpapers, 1967 at 249. Tariff concessions are important not only because import duties are generally high in developing countries but also because a significant part of production inputs is not locally available and must be imported. Consequently, import duties may form a significant part of production costs.

11. P. Robson, *Integration, development and equity; economic integration in West Africa* (1983).

profitable. For all other investments, it is, strictly speaking, an unnecessary and, therefore, a costly device.[12]

The administration of tax holidays is generally more complicated than the administration of other exemptions because time consuming controls on the implementation of the project are necessary.

Generally, the value of the tax holiday as an incentive is over-estimated[13] and in practice the tax holiday is not unconditionally popular in business circles. Firstly, effects may be limited because many firms earn little profit in their early years, whereas the period of the holiday is usually limited to 5 or 10 years. Secondly, interference in the operation of the business, as well as conditions necessary from a development point of view (minimum local content, local labor), are very unpopular with prospective investors. Thirdly, a tax holiday may encourage short-term investments designed to earn profits quickly and to close at the end of the holiday period.[14] In theory, a tax holiday is neutral as to labor or capital-intensive production techniques. In practice, however, holiday periods are frequently longer for the larger investments so that capital-intensive projects tend to be favored over others.

The general remarks on the incentive package as a whole concern the question whether the present Ghana investment regime can serve as a model for other West African countries. The answer to this question can be partly positive, particularly where the choice of incentive techniques and their selective use are concerned.

As far as the beneficiaries are concerned the new package provides for a more selective use of incentives by granting them to priority investors rather than to all investors. This is consistent with the general conclusion that incentives are more likely to influence the sectoral and geographical location of an investment than to influence the overall investment volume (see footnote 9). It is also a more revenue friendly approach which is realistic, taking into account the reduced flows of foreign and national sources of development finance.

A number of critical remarks, however, can be made on the present investment regime.

1. The continued, be it more restricted, use of tariff concessions is questionable because of the distorting effect and the negative effects on ECOWAS, mentioned above.

2. Though the wide use of generous capital allowances and investment allowances is favored, their use in the construction sector is unusual because apart from the possibility to depreciate assets in 4 years (50% first year, 25% next years) there is an investment allowance of 7.5% "per annum". Investment allowances are usually granted for the first year only. Moreover, it is unclear in this situation whether the investment allowance can be enjoyed throughout all the years of the actual use of the asset or only until the book value of the asset is reduced to zero.

3. In granting incentives, no distinction is made between national and foreign investors. There are, however, two reasons to attach specific conditions to incentives granted to foreign investors.

First of all, the bulk of foreign investment is effectuated by large multinational corporations. They often have a monopoly-like position and relatively large profit margins. Moreover, they have sophisticated devices at their disposal to minimize tax liability.[15] Therefore, they should only be granted extra incentives on the condition of disclosure of all information necessary to establish the locally realized profits.

Secondly, the effectiveness of incentives, i.e. the effective decrease of the overall tax burden of the foreign investor, depends on the combined effects of the tax system of the host country and the home country.

The capital-exporting OECD countries generally tax world-wide income of their residents. West African host countries generally tax the domestic-source income of non-residents. In a non-treaty situation, double taxation of the same international investment income is normally avoided by the OECD countries by means of a foreign tax credit (direct and sometimes also indirect credit) granted in respect of actually-paid taxes similar to OECD income taxes.[16]

Consequently, in the non-treaty situation, whenever tax liability of the international investor in the West African host countries is reduced, tax liability in the OECD home country increases. Therefore, in general, tax incentives granted by West African countries which reduce the local tax liability of the international investor may not result in a reduction of his overall tax burden, but may in effect transfer revenue from the West African country to the Treasury of the OECD home country.[17] Incentives which do not reduce the

12. Lent argues that in many cases more is surrendered in terms of revenue than necessary to secure the establishment of the business. In a survey of several countries, he concludes that gross tax revenue sacrificed ranges from 2 to 13% of total tax revenue otherwise collectible. Galenson quotes a study on Ghana (1981, Ingram, Pearson) which illustrates how incentive measures resulted in investment in loss making and unwanted ventures. A case study on Sudan (1979, Acharya) illustrates the more general African experience of sector-wise misallocation due to generous incentives for industry while neglecting agriculture. Lent op. cit., Galenson op. cit.

13. See also the conclusion of the second ESCAP Seminar on foreign investment and tax administration held in Tokyo 1976. "That system (tax holiday) in many cases seemed to play only a marginal role in attracting foreign investments in the region." U.N. ESCAP *Foreign Investment and tax administration* Report of ESCAP Seminar 1976, Manila.

14. A study on Puerto Rico showed a peak in the number of business closings once their tax holidays expired. There also appeared to be a high turnover of firms whereby new firms enjoying the exemption pushed out existing firms whose holidays had expired. E. Bond, *Tax Holdiays and industry behaviour,* as quoted by Alice Galenson op. cit.

15. See footnote 8.

16. Of the 5 major capital exporting countries, the U.S.A., Japan, the U.K. and Germany grant unilateral relief against double taxation by way of foreign tax credit. France does not grant a credit but also does not include large parts of foreign-source income in taxable income.

17. Unless the home country applies the tax sparing credit.

overall tax burden of the investor are of no importance to him and by definition ineffective.

This situation could be remedied in the West African home countries by granting these incentives under the express condition that the overall tax liability of the foreign investor be reduced.

4. A more general criticism on the use of tax incentives is that prior to granting incentives to stimulate investments it would be better, first, to concentrate on the removal of obstacles to investment. Such obstacles do exist in the Ghana tax system.

First of all, the corporate tax rate (55%; 45% for agriculture) is among the highest in the world and this may well be a deterrent to national and international investments.

Secondly, the exemption from taxable income of dividends received (provided by Art. 3 of the Income Tax Decree 1975) was repealed in 1980.[18] Therefore profits are first taxed on the corporate level at 55% and then taxed for a second time at the shareholder level. In a parent-subsidiary relationship, profits are taxed more than twice because there is no special exemption for intercorporate dividends. This so-called economic double (or multiple) taxation of dividends is widely believed to have negative economic effects.[19] Many countries, therefore, have introduced a partial or complete integration of personal and corporate income taxes in order to improve economic efficiency and welfare and to increase the national rate of capital accumulation. The abolition of the 1975 relief measure is a reintroduction of this obstacle to investments.

Thirdly, there is no carry back or forward of losses in Ghana (except for the specific deduction for the agricultural sector),[20] whereas such loss offsets are generally used to minimize adverse effects of the corporate income tax on risk taking and on the establishment of new businesses which often incur losses in their earlier years.

Fourthly, capital gains, whether realized on the disposal of real estate, business assets, land, or stocks, are taxable at very high rates.[21] The productive investment of savings is one of the major problems of developing countries. The acquisition of stocks can be considered productive, especially because, in the absence of effective capital markets, highly speculative securities transactions are unlikely. The inclusion of capital gains on securities, therefore, is an obstacle to investment. Also, favorable treatment of capital gains on business assets would have a positive effect on risk taking and would increase the primary capacity of companies. Therefore, capital gains on non-speculative assets such as machinery and equipment should be excluded from the capital gains tax.[22]

Finally, one of the most important deterrents to international investments is the double taxation of investment income. Currently, only 2 treaties for the avoidance of double taxation are in effect[23] so that double taxation of Ghana-source investment income transferred abroad is only prevented insofar as the unilateral provisions of OECD countries give an effective remedy.

18. Act 398 of 1980 Income Tax Amendment Act.
19. See S. Cnossen, *Comparative tax studies: essays in honor of Richard Goode,* (1983), chapter 4. M. Feldstein, *Capital Taxation* (1983), chapter 8.
20. *African Tax Systems,* I.B.F.D., Amsterdam.
21. Idem.
22. R. Bird, O. Oldman, *Readings on taxation in Developing Countries* (1967).
23. *African Tax Systems,* I.B.F.D., Amsterdam.

THE OECD ON PERSONAL INCOME TAX

At a time when major reforms of the personal income tax are under consideration in a number of countries, OECD has just published an extensive volume on how and why systems have been evolving over the last decade with suggestions about likely future developments.[1] Its main focus is on central or federal government taxes but information is also given on state and local taxes.

The topic is approached from a number of angles. First, revenue trends are noted in the light of changing economic conditions prevailing since the mid-sixties. At that time most OECD countries relied more on revenues from personal income taxes than from any other tax source and between 1965 and the mid-seventies these revenues substantially increased, whether expressed as a percentage of GDP or total tax receipts. Since then, these ratios have remained stable or even declined. In contrast, in the few low income tax countries, mostly in the Mediterranean area, these ratios generally remained relatively stable during the late sixties and early seventies, and increased during the last decade. (See Table I.)

The report next examines the diverse techniques used by Member governments to achieve their desired differentiation of tax treatment between different categories of taxpayers. These differentiations result from a combination of several factors but each is examined in isolation: types of income that are subject to tax; the choice between the individual or married couple as the tax unit; the scope and type of reliefs given – usually tax allowances (deductions from income subject to tax) or tax credits (deductions from tax liability) and selected minimum and maximum schedule rates of tax and number of rate brackets.

Current income tax policy issues are then considered in the light of differences in country positions, ambiguities in, and conflicts between, some of the desired objectives of tax reform (e.g. neutrality, horizontal equity, tax simplification) and the various constraints on reforming the income tax system. The study makes clear that income tax changes generally involve trade-offs and that any universal solution for improving the equity and/or economic efficiency of income systems is unlikely to be possible. It notes that there is less concern these days with vertical equity through progressive schedules and more with horizontal equity and with reducing the economic inefficiencies and distortions resulting from personal income tax systems. Both these concerns have led to flattening tax rates and widening the tax base, trends which have occurred in a number of northern European and non-European OECD Member countries during recent years.

Other equity issues examined are the relative tax treatment of different sources of income, the effects of tax avoidance and evasion, the relative treatment of one-earner and two-earner couples, choices between tax allowances, tax credits and cash transfers outside the tax systems and the imposition of minimum and/or maximum liabilities on higher income groups.

Economic efficiency objectives of special relevance to the personal income tax are its influence on the amount and direction of household savings and its effect on work behaviour. The report notes that income tax provisions generally favour certain forms of investment (particularly house purchase) but that in recent years a number of countries have been providing tax incentives for investment in productive assets. The evidence on the effect of the income tax on savings and work effort is far from clear. Nonetheless, possible disincentive effects appear to be a major element in relation to reforms currently under consideration.

The report also addresses the question of governments' measures to offset the effects of inflation on income tax yields and the income distribution of taxpayers' burdens. For most governments this seems a less pressing issue than it was ten years ago when double-digit inflation prevailed in many countries, but some governments still regard it as important. The arguments for and against regularly adjusting the income tax system for inflation, and especially

Table 1

Taxes on personal income as a percentage of GDP

	1965	1970	1975	1976	1977	1978	1979	1980	1981	1982	1983
Australia	8	9	13	13	13	12	13	13	14	14	13
Austria	7	7	8	8	9	10	9	10	10	10	9
Belgium	6	9	13	13	14	15	16	15	16	17	16
Canada	6	10	11	11	10	10	10	11	12	12	12
Denmark	12	20	23	22	22	22	23	24	24	24	24
Finland	11	13	17	19	18	16	15	15	16	16	16
France	4	4	5	5	5	5	5	5	6	6	6
Germany	8	9	11	11	12	11	11	11	11	11	11
Greece	2	2	2	2	3	3	3	4	4	5	4
Ireland	4	6	8	9	9	9	9	11	11	11	12
Italy	3	3	4	5	6	7	7	8	9	10	11
Japan	4	4	5	5	5	5	6	6	7	7	7
Luxembourg	8	7	10	9	10	11	10	10	9	10	12
Netherlands	9	10	12	12	12	12	12	12	11	11	10
New Zealand	10	11	16	16	19	18	18	19	20	20	19
Norway	13	14	14	15	14	15	14	13	13	12	12
Portugal[1]	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Spain	2	2	3	3	3	4	4	5	5	5	6
Sweden	17	20	20	21	21	22	21	20	20	20	20
Switzerland	6	8	11	12	12	11	11	11	11	11	11
Turkey	4	5	7	7	8	9	9	9	10	9	8
United Kingdom	9	12	14	13	12	11	10	11	11	11	10
United States	8	10	10	10	10	10	11	11	12	12	11
Unweighted average	7	9	11	11	11	11	11	12	12	12	12

1. Cannot isolate personal and corporate income tax receipts.
Source: Revenue statistics of OECD Member countries 1965-1984 (OECD 1985).

1. *Personal Income Tax Systems Under Changing Economic Conditions.*

Table 2

Overall breakdown of the change in income tax liabilities into six explanatory components

As percentage of tax liabilities in the base year

	Years covered		Tax liabilities in base year	Changes accounted for by: The proportionate effect of a change in the number of tax units	The proportionate effect of a change in average income	Distributional effect	Real fiscal drag	Inflationary fiscal drag	The effects of formal indexation* and changes in legislation	Tax liabilities in comparison year
	Base year	Comparison year	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Australia	1975/76	1982/83	100.0	18.0	114.0	− 1.5	− 2.9	135.0	−117.7	244.9
Belgium	1975	1981	100.0	5.4	71.6	− 6.4	12.6	36.8	− 17.1	203.0
Canada	1975	1982	100.0	18.4	113.0	1.3	4.5	102.3	−106.6	233.0
									(− 99.0)	
Denmark	1975	1982	100.0	5.1	127.3	−53.3	13.6	96.5	− 89.5	199.6
									(− 93.7)	
Finland	1976	1982	100.0	11.3	91.7	− 5.2	5.7	128.1	−145.1	186.5
France	1975	1982	100.0	13.4	137.4	−12.9	10.9	158.0	−134.6	272.2
Italy	1977	1981	100.0	10.5	119.6	− 6.1	26.1	136.3	− 44.7	341.7
Japan	1975	1983	100.0	15.2	71.6	5.0	15.0	112.1	− 22.8	296.0
Netherlands	1975	1981	100.0	3.4	46.7	− 4.4	0.0	43.6	− 46.0	143.3
									(− 39.1)	
New Zealand	1975/76	1981/82	100.0	8.5	132.9	2.0	− 6.5	118.1	− 73.8	281.3
Norway	1975	1982	100.0	6.1	122.0	−55.7	38.1	290.6	−313.3	188.0
Spain	1979	1983	100.0	20.8	63.7	21.6	−13.5	42.4	− 21.3	213.8
Sweden	1975	1981	100.0	9.6	78.4	− 9.0	−15.6	140.1	−184.1	119.4
									(− 64.4)	
Switzerland	1975	1980	100.0	11.1	10.7	− 8.6	− 2.4	12.7	1.6	125.2
United Kingdom	1975/76	1981/82	100.0	5.9	117.4	7.0	− 1.9	124.9	−159.7	193.7
United States	1975	1983	100.0	16.7	89.2	7.1	3.9	69.7	− 64.8	221.7
Ireland	1980/81	1981/82	100.0	3.1	15.9	0.5	− 2.6	12.5	− 4.6	124.9

* The effect of formal indexation provisions is shown in parentheses.

by means of formal indexation provisions, are summarised and an analysis is made of how indexation works in practice. It is noted that in recent years Switzerland and the United States have adopted indexation at a time when Australia, Denmark and Sweden have abandoned it. Thus no single tendency exists. Also there seems no evident correlation between formal indexation and the degree to which inflationary fiscal drag has been offset. Some countries without indexation fully or more than fully offset the effects of inflation annually and others with indexation sometimes apply it only partially or not at all.

The report finally summarises the results of a separate quantitative study[2] which for the first time applies common methodology to 17 countries. It comments on how personal income tax systems have been affected by, and adjusted for, economic and demographic changes over the last decade. Its main conclusion is that, subject to certain qualifications, inflationary fiscal drag has been the main cause of upward pressure on income tax rates and that its effects have been substantially but not entirely offset by changes in tax legislation in nearly all of these countries. (See Table 2.)

The report also contains five annexes. Annex I gives a comprehensive description of the main income tax provisions of all OECD countries save Iceland in 1983 and the most important changes between 1975 and 1983. Annex II updates this information to 1985. Annex III provides an analysis of revenue trends in taxes other than the personal income tax. Annex IV reproduces economic indicators for the participating countries and Annex V a selected bibliography.

2. *An Empirical Analysis of Changes in Personal Income Taxes.*

UNITED KINGDOM:

Budget 1986-87

The Government's purpose is to make the British people a nation of shareowners

Extracts from the Budget Speech presented by the Chancellor of the Exchequer, the Rt. Hon. Nigel Lawson, M.P. on 18 March 1986

Fall in the oil price

The background to this year's Budget is the dramatic and unprecedented fall in the world oil price. But the Government's objectives remain unchanged: the conquest of inflation and the creation of an enterprise culture.

And the Government's policies are unchanged, too: policies of sound money and free markets. Not least, because these are the only routes to more jobs, and jobs that last.

So my Budget today will carry forward the themes of my two previous Budgets, and sow some seeds for the future. In the course of my speech I shall begin by reviewing the general economic background to the Budget, and go on to deal with the specific issue of oil.

I shall next discuss monetary policy and the fiscal prospect, both this year and next.

I shall then turn to the question of direct help for the unemployed.

Finally, I shall propose some changes in taxation designed to assist in achieving the economic objectives I have already outlined.

...

However, not only have the tax revenues this year from the 95% of the economy that is not oil proved to be notably buoyant, but there is every sign that this will continue into 1986-87, assisted by a rather higher rate of economic growth than was foreseen in last year's MTFS.

This continued vigour of the non-North Sea economy, which is likely to add more than £3bn to expected non-North Sea tax revenues, coupled with public spending which remains under firm control, has transformed what might have been a bleak prospect.

As a result, I am able this year to accommodate a relatively modest net reduction in the real burden of taxation, of a shade under £1bn.

It may well be that the oil price turns out to be different from the average of $15 a barrel, which I have assumed for this year's Budget. But if any departure is purely short term, it is most unlikely to have any significance for policy.

Unemployment

I turn now to the continuing problem of high unemployment.

It is a problem that *can* be solved – and there is no secret about how. The solution to the problem of unemployment – and it is the *only* solution – requires progress on two key fronts.

The first is a sustained improvement in the performance of business and industry, and thus of the economy as a whole. That is what every aspect of the Government's economic policy has been designed to assist, and it is already achieving impressive results.

The second is a level of pay which enables workers to be priced *into* jobs instead of pricing them *out* of jobs, and which in particular ensures that British industry can hold its own against our major industrial competitors.

It is here that Britain's weakness lies. For the plain fact is that labour costs per unit of output in British business and industry continue to rise faster than is consistent with low unemployment and faster than our principal competitors overseas.

Productivity is, indeed, rising quite rapidly. But pay is rising faster still.

It is this – and not our alleged dependence on oil – that constitutes the Achilles heel of the British economy.

And in a free economy – as the CBI has frankly and commendably acknowledged – it is the responsibility of employers and management to control industry's cost structure in general and its wage costs in particular.

In the new and improved climate of industrial relations, and with inflation falling and set to fall further, there can be no excuse for failure to discharge that responsibility.

I have, however, considered whether there is anything further Government can do to assist this over the longer term.

The problem we face in this country is not just the level of pay in relation to productivity, but also the rigidity of the pay system. If the only element of flexibility is in the numbers of people employed, than redundancies are inevitably more likely to occur.

One way out of this might be to move to a system in which a significant proportion of an employee's remuneration depends directly on the company's profitability per person employed.

This would not only give the workforce a more direct personal interest in their company's success, as existing employee share schemes do. It would also mean that, when business is slack, companies would be under less pressure to lay men off; and by the same token they would in general be keener to take them on.

This would clearly be in industry's own interest and most emphatically in the best interests of the unemployed. It should therefore occur without any prompting from Government, but there is considerable inertia to overcome.

So it might make sense to offer some temporary measure of tax relief to the employees concerned to help get profit sharing agreements of the right kind off the ground and to secure the benefits that would undoubtedly accrue if they really caught on.

Inevitably, the design of such a relief, and the precise definition of qualifying agreements, would need to be drawn with considerable care.

The Government therefore propose to discuss with employers and others to see if a workable scheme can be defined which offers the prospect of a worthwhile and broadly-based take up.

...

Business taxation

I now turn to the taxation on business and enterprise. While the measures I have just announced help the unemployed directly, in the long run what really matters is the creation of a climate in which business and industry flourish. For it is companies, not governments, which create jobs.

The reformed system of business taxation which I introduced in my 1984 Budget has reached the end of its transitional phase and comes fully into force next month. From then on the U.K. will have, at 35%, the lowest rate of Corporation Tax of any major industrial nation. This year I have only two further amendments to make:

First, I propose to ensure a full measure of depreciation for tax purposes for short-life agricultural buildings and works, by giving the taxpayer the option of making balancing adjustments on the sale or destruction of such buildings.

Second, I propose to reform the mines and oil wells allowances broadly along the lines of the proposals published in last July's consultative document.

The overall net benefit of this to the industries concerned will amount to £45m in 1987-88.

Otherwise I propose only minor technical changes to the taxation of North Sea oil; but I am continuing to keep the economics of incremental investment under review, and shall not hesitate to introduce at the earliest opprtunity any changes which may prove necessary to ensure that worthwhile projects are not frustrated by the fiscal regime.

I need to set the 1987-88 car and fuel benefit scale charges for those with company cars. At the same time, the motor industry has represented to me that the discrepancy between the engine size break points in these scales and the break points in the new European Community directive on car exhaust emissions is potentially damaging to its international competitiveness.

Accordingly I propose, from April 1987, to change our break points to those in the new directive. At the same time, as last year, I propose to increase the (restructured) car benefit scale charges well short of the true value of the benefit.

The fuel scale will also be restructured, but there will be no general increase in the charges; and, as from April 1987, the same scale will also be used to assess the VAT due on petrol used by registered traders and their employees.

This will be simpler and more equitable than the present system, and will also bring in an extra £40m of revenue in 1987-88.

VAT threshold raised

I propose to increase the VAT threshold to £20,500, in line with the maximum permitted under existing European Community law.

Foreign entertainers and sportsmen

I also propose to correct an anomaly in the taxation of international entertainers and sportsmen. When British entertainers or sportsmen work overseas, the foreign tax authorities normally levy a withholding tax on their earnings.

But at the present time we levy no such tax on the earnings of foreign entertainers and sportsmen when they work in the U.K.

I believe that, in future, we should fall into line with most of the rest of the world. Accordingly, I propose to withhold tax at the basic rate on the earnings of overseas entertainers and sportsmen in the U.K. This should yield £75m in 1987-88.

Gift tax abolished

My last proposal in this section concerns Capital Transfer Tax, which ever since its introduction by the Labour Government in 1974 has been a thorn in the side of those owning and running family businesses, and as such has had a damaging effect on risk-taking and enterprise within a particularly important sector of the economy. In addition to statutory indexation of the thresholds and rate bands, I propose this year to reform the tax radically.

In essence, the Capital Transfer Tax is two taxes, as its two separate scales imply: an inheritance tax and a lifetime gifts tax.

We have had an inheritance tax in some shape or form ever since Sir William Harcourt introduced his Estate Duty in 1894. But the lifetime gifts tax which the Labour Government introduced in the teeth of united Conservative opposition, is an unwelcome and unwarranted impost.

By deterring lifetime giving, it has had the effect of locking in assets, particularly the ownership of family businesses, often to the detriment of the businesses concerned.

Accordingly, I propose to abolish entirely the tax on lifetime gifts to individuals.

As with the old Estate Duty, there will be a tapered charge on gifts made within seven years of death and provisions to charge gifts made with reservation; and the regime for trusts, which is needed as a protection for the death charge, will be kept broadly unchanged.

The cost of abolishing the tax on lifetime giving will be £35m in 1986-87 and £55m in 1987-88.

In recognition of the radically changed nature of the tax I haved decided to rename it the Inheritance Tax. My two previous Budgets abolished three unnecessary taxes: The National Insurance Surcharge, the Investment Income Surcharge, and Development Land Tax. The abolition of the tax on lifetime gifts adds a fourth.

Savings and investment

I now turn to the taxation of savings and investment. In my 1984 Budget, I introduced a major reform of the taxation of savings and investment designed to improve the direction and quality of both. Today I propose to carry this reform further forward.

The Social Security Bill now before Parliament proposes important and far-reaching changes in pension provisions, notably by encouraging the growth of personal pensions. Those changes – to which the Government attaches the highest importance – have been warmly welcomed, both for the greater freedom they will give to existing pension scheme members and for the new scope they will offer to the millions of working people who are not in an occupational pension scheme.

In the light of these changes, I intend later this year to publish detailed proposals designed to give personal pensions the same favourable tax treatment as is currently enjoyed by retirement annuities. Publication of these proposals will enable there to be the widest possible consultation prior to legislation in next year's Finance Bill.

Meanwhile, I can assure the House that, as I made clear last year, I have no plans to change that favourable tax treatment.

Share transfers

Next, Stamp Duty.

I have no change to propose in the Stamp Duty on houses and other property, which I reduced to 1%, with a higher threshold, in my 1984 Budget.

But there is a formidable case this year for a further reduction in the rate of Stamp Duty on share transfers.

The City of London is the pre-eminent financial centre of Europe. The massive £6bn it contributes to our invisible earnings is but one measure of the resulting benefit to the British economy.

But competition in financial services nowadays is not continental, but global. The City Revolution now under way, due to culminate with the ending of fixed commissions – the so-called Big Bang – on 27 October, is essential if London is to compete successfully against New York and Tokyo.

And if London cannot win a major share of the global securities market, its present world pre-eminence in other financial services will be threatened.

Successful competition depends on a number of factors, but one of the most important is the level of dealing costs.

The abolition of fixed commissions will certainly help. But with no tax at all on share transactions in New York and roughly ½% in Tokyo, under the existing tax regime London will still be vulnerable. I therefore propose to reduce Stamp Duty on share transactions from 1% to ½% as from the date of the Big Bang.

But I believe it is right that the full cost of this should be met from within the financial sector itself. Accordingly, I propose to bring into tax at the new ½% rate a range of financial transactions which are at present entirely free of Stamp Duty.

These include transactions in loan stock other than short bonds and gilt edged securities, transactions unwound within a single Stock Exchange account, letters of allotment, the purchase by a company of its own shares and takeovers and mergers.

There will also be a special rate of 5% on the conversion of U.K. shares into ADRs and other forms of depositary receipt. Some of these changes, including the new ADR charge, will take effect immediately; others will be delayed until the Big Bang.

This further halving of the stamp duty on equities should enable London to compete successfully in the worldwide securities market. It will also provide a further fillip to wider share ownership in the U.K.

Encouraging small shareholders

Just as we have made Britain a nation of home owners, it is the long-term ambition of this Government to make the British people a nation of share-owners, too; to create a popular capitalism, in which more and more men and women have a direct personal stake in British business and industry.

But through the rapid growth of employee share schemes, and through the outstandingly successful privatisation programme, much progress has been made. But not enough.

Nor, I fear, will we ever achieve our goal so long as the tax system continues to discriminate so heavily in favour of institutional investment rather than direct share ownership.

Accordingly I propose to introduce a radical new scheme to encourage direct investment in U.K. equities. Starting next January, any adult will be able to invest up to £200 a month, or £2,400 a year, in shares. These will be held in a special account which I am calling a Personal Equity Plan.

So long as the investment is kept in the plan for a relatively short minimum period, of between one and two years, all reinvested dividends, and all capital gains no disposals, will be entirely free of tax.

The longer the investment is kept in the plan, the more the tax relief will build up and the greater will be the benefits. And there will normally be no need for the Inland Revenue to get involved at all.

Although the scheme will be open to everyone, it is specially designed to encourage smaller savers, and particularly those who may never previously have invested in equities in their lives. So the plans will be simple and flexible to operate.

Anyone who is legally able to deal in securities will be eligible to register as a plan manager. But the investor himself will own the shares, and the rights that go with them, including voting rights. And it will be for the investor to choose whether to make the investment decisions himself or to give the plan manager authority to act on his behalf.
The cost of the scheme will be around £25m in 1987-88, but will build up in later years as more plans are taken out.
This is a substantial, innovative and exciting new scheme. I am confident that, over time, it will bring about a dramatic extension of share ownership in Britain.
Although wholly different in structure from the *Loi Monory* in France, I expect it to be every bit as successful in achieving its objective.
I am sure the the whole House will welcome this far-reaching package of measures to reform the taxation of savings and investment.

Charities

I now turn to the tax treatment of charities and charitable giving. In almost every facet of the nation's affairs if becomes increasingly clear that private action is more effective than state action.
This is particularly well-illustrated by the success of charitable organisations up and down the land in the fields of famine relief, social welfare, medicine, education (including the universities), the arts and the heritage.
This Government has already done a great deal to assist charities both through the tax system and in other ways. I believe the time has come to take a further step forward.
The first question is whether any further fiscal relief should be given to the charities themselves, through relief from VAT, or to the act of giving.
In the light of representations from the Charities VAT Reform Group, I am prepared this year, exceptionally, to make a number of specific concessions on the VAT front.
I propose to relieve charities from VAT on their non-classified Press advertising; on medicinal products where they are engaged in the treatment or care of people or animals; or in medical research; on lifts and distress alarm systems for the handicapped; on refrigeration and video equipment for use in medical applications purchased by charities from donated funds; on all recording equipment for talking books and newspapers used by charities for the blind; and on welfare vehicles used by charities to transport the deaf, blind or mentally handicapped.
But in general I am convinced that the right way to help charities is not by relieving the charities themselves from VAT, but by encouraging the act of charitable giving.
I say this for two principal reasons. First, it is clearly better that the amount of that relief is related to the amount of support a charity is able to attract, rather than to the value of goods and services it happens to purchase.
And, second, whereas a pound of VAT relief is worth precisely that, a pound of tax relief on giving is likely to generate more than a pound of income going to charity. My principal proposals therefore relate directly to the act of giving to charity.
First, I propose to abolish althogether the upper limit on relief at the higher rates of income tax on charitable covenants.
At the same time I propose to act to stop the abuse of the tax system by ensuring that tax relief goes only to money which is used for charitable purposes.
Next companies.
It is widely believed that corporate giving to charity would be more generous than it is at present if tax relief did not depend on the company entering into a four-year covenant.
Accordingly, I propose to allow public companies to enjoy tax relief on one-off gifts to charity up to a maximum of 3% of the company's annual dividend payment to its shareholders. There will, of course, continue to be no limit on the amount a company can covenant to charity.
Many charities have made clear to me their fear that to introduce a similar relief for one-off donations by individuals would weaken them by reducing the stability they enjoy as a result of the binding force of covenants. Instead, therefore, I propose to encourage individual giving to charity by a different means, that of tax relief for payroll giving.
From April 1987 it will be open to any employer to set up a scheme under which employees can have charitable donations of up to £100-a-year deducted from their pay, and get tax relief on them.
All in all, the proposals I have announced today add up to a very substantial package of assistance to charities and charitable giving. Their cost to the exchequer will depend on how generously companies and employees respond to this initiative. But my best estimate is that it could amount to as much as £70m in 1987-88.
This will be partly paid for by the measures to curb abuse, which may save some £20m a year. I would hope, too, that the additional charitable giving these concessions stimulate will be at least twice the amount of the extra tax relief given.

Taxes on spending

I now turn to the taxation of spending.
So far as the indirect taxes are concerned, the overriding question this year is how far I should recover from the oil consumer the tax revenues I have lost from the oil producer, as a result of the massive fall in the oil price.
Since November, the price of petrol at the pump has fallen by anything up to 15 pence a gallon. But if the oil companies had passed on the full amount of the fall in the oil price to date, the price of petrol at the pump could have been 12 pence a gallon lower still. There is clearly scope, therefore, for a sizable increase in petrol tax this year.
I have concluded, however, that at the present time, while I must certainly maintain the real value of the revenue I get from the motorist, I will not increase it.
But I do believe it makes sense to look again, in the light of the radically changed circumstances, at the relative weight of petrol tax and Vehicle Excise Duty. Accordingly, I propose to increase the duty on petrol by an amount which, including VAT, would – if it were wholly passed on to the consumer – raise the price at the pump by 7½p a gallon. This is twopence more than is needed to keep pace with inflation, and that enables me to keep VED at last year's level of £100 for cars and light vans, leaving the overall burden on the motorist unchanged in real terms.
Moreover, given the very substantial increase in the oil companies' margins, there is clearly no need for the pump price of petrol to go up at all.
Indeed, it ought to fall further.
In the same way, I propose to increase the duty on derv by an amount which – if it were wholly passed on to the consumer, which, to repeat, it should certainly not be – would raise the price at the pump by 6½p including VAT.
This will enable me to avoid any general increase this year in the Vehicle Excise Duty on lorries, too.
So far as the other oil duties are concerned, I have one or two changes to make, not to the duty on heavy fuel oil, which will remain unchanged as it has done since 1980. But I propose to increase the very modest duty on gas oil, by 1½p a gallon.
And I propose to abolish altogether the duties on aviation kerosene, or Avtur – which at present is taxed for domestic flights only – and on most lubricating oils. All these changes in duty will take effect from 6 pm this evening.
Finally, so far as oil products are concerned, I am anxious to do what I reasonably can to assist the introduction of leadfree petrol. The case for this on environmental grounds is clear.
I have therefore decided to create a duty differential in its favour to offset its higher production costs. My officials will be discussing with the oil companies how this can best be achieved in time for next year's Budget.
Next, tobacco. In the light of the representations I have received on health grounds, I have decided to increase the duty on cigarettes by appreciably more than is needed to keep pace with inflation.
I therefore propose an increase in the duty on cigarettes and hand-rolling tobacco by the equivalent, including VAT, of the approximately 11p on a packet of 20 cigarettes.
This will take effect from midnight on Thursday. As last year, I propose no increase at all on the duties on cigars and pipe tobacco, which are more heavily taxed here than in most comparable countries.
Finally, drink. As the House will recall, I was obliged in 1984 to increase the duty on beer by slightly more than I would have wished as a consequence of the judgement against the U.K. in the European Court of Justice.
I now propose no increase at all in the duty on beer. Nor do I propose any increase in the duties on cider, table wine, sparkling wine, fortified wine or spirits. This last decision will, I hope, be particularly welcome in Scotland.
Next, VAT. I propose to stop the misuse of

long stay relief for hotel accommodation, and make certain other minor changes. But I have no proposals for major changes in value added tax this year.

...

Income tax

Finally, I turn to income tax. In my Budget speech last year I undertook to issue a Green Paper on the reform of personal taxation. As the House is aware, I am publishing the Green Paper today.

It dicusses a range of options which will in due course be opened up by the computerisation of PAYE, from the relationships between income tax and employees' national insurance contributions to the closer integration of the tax and benefit systems.

In particular, however, it outlines a possible reform of the present system of personal allowances. The responses to my predecessor's 1980 Green Paper revealed widespread dissatisfaction with the existing arrangements, but – inevitably – no clear consensus as to what should replace them.

Married women increasingly resent the fact that a wife's income is treated for tax purposes as that of her husband, depriving her of the independence and privacy she has a right to expect.

There is growing complaint, too, of the way in which, in a number of respects, the present system penalises marriage itself.

And it cannot be right that the tax system should come down hardest on a married couple just at the time when the wife stops work to start a family.

Yet that is what happens today.

The alternative system set out in the Green Paper, of independent taxation with allowances transferable between husband and wife, would remedy all these defects. To be acceptable, however, it would need to be accompanied by a substantial increase in the basic threshold.

The Government is committed to reducing the burden of income tax, and the proposal in the Green Paper suggests one way of doing that which would achieve a number of other worthwhile objectives – including the ability to take more people out of the unemployment and poverty traps for a given amount of tax relief than is possible under the present tax system.

Given the timetable of computerisation, none of this could in practice be implemented until the 1990s. But we need to start planning for the 1990s today. The Government will therefore carefully consider the responses to today's Green Paper before taking any decision on how to proceed.

Meanwhile, I have to set the tax rates and thresholds for the coming year. But first I have two minor proposals to announce, both of which I hope the House will welcome.

First, pensions paid by the West German and Austrian governments to victims of Nazi persecution are free of tax in both West Germany and Austria.

In this country, however, the tax relief on such pensions is set at 50%. In future, I propose that pensions paid to victims of Nazi persecution should be free of tax altogether.

Second, the House will be aware that, as from next year, social security benefit upratings will be moved to April, to coincide with the tax year. This will enable them to be fully taken into account before PAYE codes are issued for 1987-88.

However, to bridge the gap between the November 1985 and April 1987 upratings my Right Honourable Friend the Secretary of State for Social Services proposes to have a special transitional uprating in July, the details of which he has recently announced.

But, as Honourable Members will know from their postbags, it could be confusing for many old-age pensioners and widows to undergo a special mid-year tax re-coding on account of the July uprating.

I have therefore decided that, for pensioners and widows, the benefit increases payable in July will be exempt from income tax in 1986-87.

The cost of this will be £15m.

Since we first took office in 1979, we have cut the basic rate of income tax from 33% to 30% and sharply reduced the penal higher rates we inherited from Labour.

We have increased the main tax thresholds by some 20% more than inflation – and the greater part of that 20% has been achieved during the present Parliament. It is a good record, but it is not good enough. The burden of income tax is still too great.

Nothing could be further from the truth than the claim that we have a choice between cutting tax and cutting unemployment. The two go hand in hand. It is no accident that the two most successful economies in the world, both overall and specifically in terms of job creation, the U.S. and Japan, have the lowest level of tax as a proportion of GDP.

Reductions in taxation motivate new businesses and improve incentives at work. They are a prinicipal engine of the enterprise culture, on which our future prosperity and employment opportunities depend.

The case for higher tax thresholds is well understood. In my two previous Budgets, I have raised the married man's allowance to its highest level in real terms since the war, and higher as a proportion of average earnings than in either Germany or the U.S.

But we should not overlook the need for reductions in the basic rate of tax, too. The basic rate is the starting rate of tax. And it is the crucially important marginal rate of tax for some 95% of all employees and 90% of all self-employed and unincorporated businesses.

Clearly, given the massive fall in oil revenues, this is not a year for substantial reductions in tax of any kind.

But provided the economy continues to grow as it has been and provided we continue to maintain firm control of public expenditure, the scope should be there in the years ahead.

Thresholds raised

Meanwhile, I propose for 1986-87 to raise all the main thresholds and allowances by the statutory indexation figure of 5.7%, rounded up.

The single person's allowance will therefore rise by £130 to £2,335 and the married man's allowance by £200 to £3,655.

Similarly, the single age allowance will rise by £160 to £2,850 and the married age allowance by £250 to £4,505. The age allowance income limit becomes £9,400.

I propose to raise all the higher rate thresholds by exactly £1,000. This is fully in line with statutory indexation for the first (40%) higher rate, but less than half statutory indexation for the top (60%) rate.

Given the need for caution in the light of current circumstances, I do not have scope this year for a reduction in the basic rate of income tax, beyond one penny in the pound.

But this reduction from 30% to 29% still represents the first cut in the basic rate of income tax since my predecessor took it down from 33% to 30% in 1979.

So long as this Government remains in office, it will not be the last. There will, of course, be a consequential reduction in the rate of Advance Corporation Tax.

And I also propose a corresponding cut in the small companies' rate of Corporation Tax from 30% to 29%.

The combined effect of the various income tax changes I have just announced is to concentrate the benefit, modest as I readily concede it to be, not on the rich but on the great majority of ordinary taxpayers.

As a result of the adjustments I have made to the higher rate thresholds, the gain for those at the top of the income scale is more or less confined to what they would have received under simple indexation alone.

By contrast, the married man on average earnings will be some £2.60 a week better off, an improvement of £1.45 a week over simple indexation alone.

The income tax changes I have announced today will take effect under PAYE on the first pay day after 17 May. They will cost £935m in 1986-87, over and above the cost of statutory indexation.

Seven years ago, when my predecessor cut the basic rate of income tax from 33% to 30%, he added: "Our long-term aim should surely be to reduce the basic rate of income tax to no more than 25%."

I share that aim.

In this Budget, Mr. Deputy Speaker, I have reaffirmed the prudent policies that have brought us three successive years of steady growth with low inflation, and the prospect of a fourth ahead of us.

I have described how we can take in our stride the dramatic collapse in the oil price, and benefit from its consequences.

In collaboration with my Rt Hon and Noble Friend, the Secretary of State for Employment, I have announced a further substantial range of measures to help the unemployed.

I have proposed a radical and far-reaching new scheme for tax-free investment in equities, so that we may truly become a share-owning democracy, and abolished a fourth tax.

I have announced the most substantial package of assistance to charitable giving ever and cut the basic rate of income tax.

Building as it does on the achievements of the recent past, this Budget is a safeguard for the present and a springboard for the future.

I commend it to the House.

INTERNATIONAL FISCAL ASSOCIATION NEWS

U.S.A. BRANCH

On 27 and 28 February 1986 the U.S.A. Branch of IFA held its Annual Meeting in New York. A number of papers read at the convention which were in publishable form are reproduced below.
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U.S.A.:

International Tax Aspects of the Transfer or Use of Intangibles*

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Contents

I. INTRODUCTION

1. Multinational corporations that own valuable intangible assets used in their international operations have special tax planning opportunities available to them. They also may face tax issues unique to the intangibles area.

2. This outline considers related party and other transactions involving intangible assets.

II. THE § 482 "INTANGIBLES" REGULATIONS

1. Treas. Reg. § 1.482-2(d) deals with the transfer or use of intangible property. Intangible property also is relevant in considering intercompany services and sales of tangible property.

2. Treas. Reg. § 1.482-2(d), however, does little more than indicate that "an arm's length consideration is an arm's length consideration" and it offers no real guidance.

3. Treas. Reg. § 1.482-2(d)(3) defines intangible property in a very broad manner. Intangible property consists of the following items, provided they have substantial value independent of the services of individual persons:

A. patents, inventions, formulas, processes, designs, patterns, and other similar items;
B. copyrights, literary, musical or artistic compositions, and other similar items;
C. trademarks, trade names, brand names, and other similar items;
D. franchises, licenses, contracts, and other similar items; and
E. methods, programs, systems, procedures, campaigns, surveys, studies, forecasts, estimates, customer lists, technical data, and other similar items.

*The major IRC sections have been reproduced in an Appendix at the end of the article. Unfortunately, we are unable to reproduce the regulations.

4. Application of Treas. Reg. § 1.482-2(d).

A. Treas. Reg. § 1.482-2(d) applies whenever intangible property or an interest in intangible property is "transferred, sold, assigned, loaned, or otherwise made available in any manner" to a related corporation. Treas. Reg. § 1.482-2(d)(1)(ii)(a).

B. It provides that when the group develops intangible property, the "developer" generally is the corporation that incurred the cost and risks of development. Treas. Reg. § 1.482-2(d)(1)(ii)(c). See *Ciba-Geigy Corp.*, 85 T.C. No. 11 (1985) for an application of the "developer" rules.

C. The "developer" is deemed to have transferred an interest in the intangible property when any related corporation "acquires an interest in the property developed by virtue of obtaining a patent or copyright, or by any other means." Treas. Reg. § 1.482-2(d)(1)(ii)(a).

5. Determining the consideration.

A. Form.

(i) The regulation provides that an arm's length consideration for an intangible must "be in a *form* which is consistent with the form which would be adopted in transactions between unrelated parties under the same circumstances," i.e. royalties, lump-sum payments or "any other form," including reciprocal licensing. Treas. Reg. § 1.482-2(d)(2)(i).

(ii) However, the related parties must be able to establish that this form was adopted pursuant to an arrangement that in fact existed between them. Id.

(iii) Where the transferee pays nominal or no consideration *and* where the transferor has retained a substantial interest in the property, the regulation provides that an allocation shall be presumed not to take the form of a lump-sum payment. Id. The regulation does not indicate what constitutes a "substantial interest" and presumably resort to case law is necessary. See, for example, *E. I. DuPont de Nemours and Co. v. United States,* 432 F.2d 1052 (3d Cir. 1970), and *Bell Intercontinental Corporation v. United States,* 381 F.2d 1004 (Ct. Cl. 1967); see also Treas. Reg. § 1.1235-2(b).

B. Amount.

(i) The regulation indicates that in determining the *amount* of an arm's length consideration "the standard to be applied is the amount that would have been paid by an unrelated party for the *same* intangible property under the *same* circumstances" and that "where there have been transfers by the transferor to unrelated parties involving the *same or similar* intangible property under the *same or similar* circumstances the amount of the consideration for such transfers shall generally be the best indication of an arm's length consideration." Treas. Reg. § 1.482-2(d)(2)(ii).

(a) See generally *Ciba-Geigy Corp.*, 85 T.C. No. 11 (1985), for an excellent discussion of this subsection of the regulation and comparability in general.

(b) Curiously, the 1985 House Ways and Means Committee Report accompanying H.R. 3838, the "Tax Reform Act of 1985," (Dec. 7, 1985) states at p. 424 that case law "unduly emphasize(s) the concept of comparables . . . [and that the Committee] believes that such an approach is sufficiently troublesome where transfers of intangibles are concerned that a statutory modification to the intercompany pricing rules regarding transfer of intangibles is necessary." (See Section III.9 below.) Case law? The regulations offer no alternatives to utilizing a "comparable" approach.

(ii) Where a "sufficiently similar" transaction involving an unrelated party cannot be found, Treas. Reg. § 1.482-2(d)(2)(iii) indicates that the following factors *may* be considered:[1]

(a) the prevailing rates in the same industry or for similar property,
(b) the offers of competing transferors or the bids of competing transferees,
(c) the terms of the transfer, including limitations on the geographic area covered and the exclusive or nonexclusive character of any rights granted,
(d) the uniqueness of the property and the period for which it is likely to remain unique,
(e) the degree and duration of protection afforded to the property under the laws of the relevant countries,
(f) the value of services rendered by the transferor to the transferee in connection with the transfer,
(g) the prospective profits to be realized or costs to be saved by the transferee through its use or subsequent transfer of property,
(h) the capital investment and starting up expenses required of the transferee,
(i) [omitted from the regulations],
(j) the availability of substitutes for the property transferred,
(k) the arm's length rates and prices paid by unrelated parties where the property is resold or sublicensed to such parties,
(l) the costs incurred by the transferor in developing the property, and
(m) any other fact or circumstance which unrelated parties would have been likely to consider in determining the amount of an arm's length consideration for the property.

6. Treas. Reg. § 1.482-2(d)(1)(ii)(b) sets forth a special provision concerning assistance in development efforts. Note the availability of "multi-year" set-off

1. The Tax Court discussed a number of these factors in *Ciba-Geigy Corp.*, 85 T.C. No. 11 (1985), specifically factors (a), (b), (g) and (h).

relief. See Treas. Reg. § 1.482-2(d)(1)(ii)(d) example no. 3. Compare Treas. Reg. § 1.482-1(d)(3), limiting the general set-off relief provisions to transactions that took place in the same taxable year.

7. Lastly, Treas. Reg. § 1.482-2(d)(4) provides for cost sharing agreements.

III. DETERMINING AN ARM'S LENGTH ROYALTY RATE

1. There is a substantial body of case law concerning the determination of an arm's length consideration in the context of related-party transactions involving the transfer or use of intangible property. Most of these cases involved the deductibility of the user-licensee's royalty payments, which requires the determination of an arm's length price.

A. Many of these cases resulted in taxpayer victories, usually on the basis of evidence demonstrating that the related-party royalty rate was in accord with *comparable uncontrolled prices.*
   (i) In a 1984 IRS report, the Service stated that 32% of the intangible adjustments were made based on comparable uncontrolled prices. This differs from a 1981 GAO report setting the figure at 5%.
   (ii) Note the comments above in Section II.5.B(i) with respect to comments made in the House Ways and Means Committee Report accompanying H.R. 3838, the "Tax Reform Act of 1985" (p. 424). The use of comparables was criticized, specifically with respect to intangibles. See 9. below.

B. Many of the cases discussed below involved patent sales where the consideration was based upon a percentage of the related purchaser's sales. However, the basic issue was the same: what constitutes an arm's length consideration? See *Myron C. Poole,* 46 T.C. 392, 407 (1966), *acq.* Payments of such a purchase price are deductible under *Associated Patentees,* 4 T.C. 979 (1945), *acq.,* and will not be distinguished here from royalties paid under a license. However, it should be noted that the tax consequences are substantially different if the "licensee" is actually the owner and it sells the patent. See *Newton Insert Co.,* 61 T.C. 770 (1974), *reviewed by the Court, aff'd,* 545 F.2d 1259 (9th Cir. 1977); *Allied Tube and Conduit Corp.,* 34 T.C.M. 1218 (1975); and *Johnson v. United States,* 75-2 U.S.T.C. ¶ 9761 (N.D. Cal. 1975). Moreover, the tax consequences to the "licensor" may be different depending upon whether the transaction is a license or a sale, but in light of §§1249 and 1253, the issue of ordinary income vs. capital gains will not be considered here.

2. Almost no consideration was given in these cases (with one exception) to the parties' *profit split.*

A. An important exception, however, is *Ciba-Geigy Corp.,* 85 T.C. No. 11 (1985), where the IRS argued ("repeatedly") that, "as a rule of thumb, a royalty rate generally divides net profits before royalties 25/75 between the licensor and licensee, respectively." The court noted that the licensee retained more than 80% of the net profits before royalties, and didn't address the argument any further.

B. TAM 7704079940A and TAM 8002001, supplemented TAM 8002014, (apparently involving the same taxpayer) discuss compensation for intangibles on a profit-split basis, but are somewhat vague on this point.

C. A study by the Conference Board seems to indicate that IRS agents generally do (did) not consider the parties' profit split in licensing transactions, at least unless the related licensee sublicenses the property. See Duerr, "Tax Allocations and International Business," Conference Board Report No. 555 (1972) (hereafter cited as "Conference Board Report"), at 36.

D. H.R. 3838, the "Tax Reform Act of 1985" § 641, would amend § 367(d) (and have similar rules apply for purposes of § 482) to require that amounts taken into income for the transfer of intangibles be "commensurate with the income attributable to the intangible." Although the breadth of the provision is unclear (the revenue estimate for 1986 is "only" $16 million [excluding Puerto Rico]), query whether it involves or will evolve into (if enacted) some sort of profit split approach or require a profit split analysis?

3. Royalty rates that have been blessed in prior cases, of course, are not directly relevant in planning for the future or in defending an existing royalty structure. However, the factors and methods used in successfully establishing or defending royalty structures and rates are relevant. Evidence of comparable uncontrolled pricing was considered in nine cases as follows:

A. In *Ciba-Geigy Corp.,* 85 T.C. No. 11 (1985), the intercompany royalty rate was 10%. The IRS contended this was too high. A DuPont senior patent attorney testified that, in negotiations with Ciba-Geigy, DuPont was willing to pay 10-12.5%. Evidence of DuPont's *offer* was the key to the taxpayer's victory. The taxpayer's and the Service's comparables were rejected by the Court as not arising "under the same or similar circumstances." The taxpayer-licensee had the right to manufacture whereas the licensees in the taxpayer's purported comparable transactions had to purchase the active ingredients from Ciba-Geigy Basel (the licensor). Thus, the taxpayer-licensee had to invest *capital* and incur *risk.* The IRS was unable to produce evidence showing "similar circumstances" with respect to its purported comparable transaction. The Service's principal argument was that the U.S. subsidiary (the taxpayer-licensee) and its Swiss parent jointly developed the intangible property, but failed to prove such joint development. (This is discussed further in 8E below re "reciprocal consideration.") The IRS also raised profit split as a possibility.

B. *Photocircuits Corp. v. United States,* 74-2 U.S.T.C. ¶ 9558 (Ct. Cl. 1974). The royalty rate paid by taxpayer (originally a percentage of net sales) for the license-back of "printed circuit technology" (including certain patent rights) was approximately the rate the licensee was then paying to an unrelated party of a license of similar technology. Curiously, this type of transaction does not qualify under Treas. Reg. § 1.482-2(d)(2)(ii) (since it was not a transfer by the transferor) nor is it included as such in the list of factors set forth in Treas. Reg. § 1.482-2(d)(2)(iii), although presumably it would qualify as evidence of arm's length dealings under § 482. Interestingly, § 482 was not considered in *Photocircuits.*

C. *The R.T. French Co.,* 60 T.C. 836 (1973). The Court held that the related parties dealt at arm's length when they negotiated the license agreement since the licensee was only a 51% subsidiary at that time. Moreover, "the only agreement entered into by the licensor authorizing use of its . . . process . . was with a wholly unrelated company . . and the terms of that agreement were at least as favorable to [the licensor] as those of its agreement with the petitioner." In view of this agreement, it was "*prima facie* apparent that [the related-party] agreement was not at all unreasonable, at least from petitioner's standpoint." See also, *United States Steel Corp. v. Commissioner,* 80-1 U.S.T.C. ¶ 9307 (2d Cir. 1980) (the Court viewed evidence of pricing in comparable uncontrolled transactions as constituting a "safe harbor" under § 482).

D. *Van Dale Corp.,* 59 T.C. 390 (1972). The Court held that the transferor and the transferee were not subject to common control, but noted that "the terms existing between petitioner and [the related, but not commonly controlled] transferee, were basically identical to those offered by [an unrelated] party to acquire petitioner's patents." This "virtually eliminate[d] . . section 482 from respondent's case."[2]

E. *United States Mineral Products Co.,* 52 T.C. 177 (1969), *acq.* The taxpayer charged its related Canadian corporation $0.03 per pound of product mixed. It licensed similar property to unrelated parties in Australia and New Zealand at the same rate. Consequently, the Court held that the related-party rate satisfied arm's length standards.

F. *Magee-Hale Park-O-Meter Co.,* 15 T.C.M. 254 (1956). The taxpayer paid a royalty of $4 on each meter sold and for which payment was made. Unrelated parties in Canada and the U.K. paid at least that much. The Service argued that the U.K. and Canadian agreements were not comparable with the related-party transaction in issue because they were entered into five and eight years after the related-party agreement, during which time the value of the product had been proved. The Court stated that it could "be argued with equal validity that the amount of royalty paid by the British and Canadian manufacturers shows that Hale and his associates made an accurate estimate of the worth of their patent rights in the first place." The Court further noted that "*reasonableness . . . implies some variance and an allowable latitude.* So long as the payments in question are within a *sufficiently close range* of those in comparable arm's length transactions they meet the broad test of reasonableness." (Emphasis added.)

G. *Ransom W. Chase,* 24 T.C.M. 1054 (1965). The taxpayer paid a royalty to unrelated party "X" of 5% of its sales for the non-exclusive right to manufacture articles covered by certain patents. The taxpayer paid another 3% of its sales to unrelated party "X" because it could not successfully manufacture the devices covered by the X license without infringing on Y's patents, which were a part of the more sophisticated technology of X's patents. Y's patents expired. A partnership that was related to the taxpayer purchased X's patents and granted the taxpayer an exclusive license at 8% of net sales. Based in part upon the unrelated-party transactions, the 8% rate was held to be reasonable. The Court noted that "an exclusive license demands a higher rate of royalty because of the added protection it affords." 24 T.C.M. at 1070.

H. *Heatbath Corporation,* 14 T.C. 332 (1950), *acq.* The licensors had asked, but had not gotten, $0.06 from unrelated parties. They also had entered into one unrelated-party license at $0.05 but that unrelated party had not availed itself of privileges under the license and had paid no royalties. The Court blessed a related-party royalty rate of $0.05 per pound, although it stated that it was "extremely difficult, if not impossible, to determine from the record just what would represent reasonable compensation for the use . . . of the process" and it based its holdings on the "evidence as a whole."

I. *Keller Mines Inc.,* 21 T.C.M. 142 (1962). Evidence as to "comparable or higher royalty payments made between unrelated parties in comparable situations on comparable or less desirable . . . property" fortified the testimony of experts in the field.

4. Expert testimony.

A. Some taxpayers were not able to produce direct evidence of comparable uncontrolled prices but relied on "expert" and other testimony. "Experts" testified that the taxpayer's royalty rates were:
   (i) "in line with royalties paid on other secret or patented processes used in the same or similar fields," *The Nestle Company,* 22 T.C.M. 46 (1963);

2. With regard to using unaccepted *offers* to establish an arm's length price, see also *Ciba-Geigy Corp.,* 85 T.C. No. 11 (1985), and *Ross Glove Co.,* 60 T.C. 569, 583 and 600 (1973), *acq.,* which involved sewing services. However, with regard to third party *quotes,* compare *Diefenthal v. United States,* 367 F. Supp. 506 (E.D. La. 1973), with *Cadillac Textiles Inc.,* 34 T.C.M. 295 (1975).

(ii) that the taxpayer's license was in accord with customary practice, *Ransom W. Chase,* 24 T.C.M. 1054 (1965);

(iii) that the value added to the product through the use of intangible property justified the royalty rate, *Differential Steel Car Co.,* 16 T.C. 413 (1951), *acq.;* and

(iv) that the intangible property had great value to the licensee. *Thomas Flexible Coupling Co.,* 14 T.C. 802 (1950), *nonacq., aff'd,* 198 F. 2d 350 (3d Cir. 1952).

B. In some case, the taxpayer's customers, *Differential Steel Car Co.,* 25 T.C.M. 344 (1966), or competitors, *Keller Mines,* 21 T.C.M. 142 (1962), testified.

C. In one case, the court commented unfavorably to the taxpayer that expert testimony had not been introduced. *Ray E. Omholt,* 60 T.C. 541 (1973), *acq.*

D. In *Ciba-Geigy Corp.,* 85 T.C. No. 11 (1985), a senior patent attorney from DuPont testified for Ciba-Geigy about his negotiations with Ciba-Geigy on DuPont's behalf and what DuPont *offered* Ciba-Geigy. He also testified that unrelated parties in the industry would not have charged for certain services.

E. In a 1984 IRS report, the Service stated with respect to intangibles and § 482, an "increasing area of concern for the IRS," that 26% of the cases where *economists* were involved concerned royalties (41% involved intercompany pricing). Of the royalty issues involving economists, 66% involved the instruments industry and 13% the chemical industry.

5. Special problems of proof.

A. *Bargain acquisitions.* In cases where the licensor was able to acquire the property at a bargain price, the bargain acquisition did not affect determination of the arm's length royalty rate. *Robert L. Merritt,* 39 T.C. 257 (1962), *acq., rev'd on another issue,* 330 F.2d 161 (4th Cir. 1964), *Fourth Circuit rev'd sub nom., Paragon Jewel Coal Co. v. Commissioner,* 380 U.S. 624 (1965); and *Keller Mines,* 21 T.C.M. 142 (1962); see also *Ransom W. Chase,* 24 T.C.M. 1054 (1965).

B. *Special advantages.* The courts have held that any special advantages that the particular property offers to the licensee should be considered. *The Nestle Co.,* 22 T.C.M. 46 (1963) (the licensor's continuing research); *Keller Mines,* 21 T.C.M. 142 (1962) (geographic advantages); and *Myron Poole,* 46 T.C. 392 (1966) *acq.* (protected existing patents); see also *Differential Steel Car Co.,* 25 T.C.M. 344 (1966) (the court noted that the patents involved relatively minor improvements and were comparatively narrow in scope).

C. *Relevant facts and circumstances.* Relevant facts and circumstances were those that existed at the time the parties entered into the agreement. *The R.T. French Co.,* 60 T.C. 836 (1973); and *John T. Potter,* 27 T.C. 200 (1956), *acq.;* see also *Magee-Hale Park-O-Meter Co.,* 15 T.C.M. 254 (1956). See, however, TAM 8002001, supplemented, TAM 8002014 (if the agreement has periodic termination provisions, the IRS says the bona fides of the agreement will have to be retested periodically to see whether unrelated parties would cancel the agreement). This seems to be a main area of concern under H.R. 3838, the "Tax Reform Act of 1985," discussed above and in 9. below.

D. *The unrelated parties' "knowledge".* One court imputed to the hypothetical unrelated party "all the information [the licensor] had as an officer of [the licensee corporation]." *Robert L. Merritt,* supra. DuPont's knowledge of Ciba-Geigy's intangible property was discussed in *Ciba-Geigy Corp.,* 85 T.C. No. 11 (1985).

E. *Boiler plate language.* The IRS argued in a number of cases that insufficiencies in the parties' license agreements should preclude the courts from holding that the transactions were at arm's length. However, most courts have not accorded much significance to the absence of "boiler plate", letter-perfect agreements. See *The Nestle Co.,* 22 T.C.M. 46 (1963); *Magee-Hale Park-O-Meter Co.,* 15 T.C.M. 254 (1956); *Roy J. Champayne,* 26 T.C. 634 (1956) *acq.;* and Heatbath Corp., 14 T.C. 332 (1950), *acq.* Inconsistencies in documentation and a failure to adhere to written agreements, however, were damaging in a couple of cases. See *Roy E. Omholt,* 60 T.C. 541 (1973), *acq.;* and *Differential Steel Car Co.,* 25 T.C.M. 344 (1966). In TAM 8240010 failure to adhere to a DISC agreement did not evidence the necessary good faith.

F. *Revisions.* The courts have recognized that unrelated parties may revise a license agreement during its term. See *The R.T. French Co.,* 60 T.C. 836 (1973); and *The Nestle Co.,* 22 T.C.M. 46 (1963). However, this doesn't mean letting the licensee "off the hook." See, generally, *The R.T. French Co.*

G. *"As of" agreements.* Some courts have blessed agreements that were executed some months after their effective dates. *United States Mineral Products Co.,* 52 T.C. 177 (1969), *acq.* (9 months); *Thomas Flexible Coupling Co.,* 14 T.C. 802 (1950), *nonacq., aff'd,* 198 F.2d 350 (3d Cir. 1952) (5 months); and *Myron C. Poole,* 46 T.C. 392 (1966), *acq.* (13 months); but see *Granberg Equipment, Inc.,* 11 T.C. 696 (1948) (the taxpayer failed to show that "it could not have obtained the license agreement, if one were necessary, without making the minimum royalty retroactive.").

H. *The royalty base.* Most cases involved royalties that were computed as a percentage of the licensee's sales, but a number of cases involved agreements where royalties were based on units sold or produced. *See Differential Steel Car Co.,* 25 T.C.M. 344 (1966); *United States Mineral Products*

Co., 52 T.C. 177 (1969), *acq.*; *Myron Poole*, 46 T.C. 392 (1966), *acq.*; and *Heatbath Corp.*, 14 T.C. 332 (1950), *acq.* In one case where royalties were based upon the licensee's net profits, the judge converted the royalty rate in a footnote to "the more ordinary 'percentage of gross sales.'" *Differential Steel Car Co.*, 25 T.C.M. 344 (1966); see also *George La Monte & Son v. Commissioner*, 32 F.2d 220 (2d Cir. 1929), with regard to royalties based on net profits. Minimum royalties seemed generally permissible, see *Myron Poole*, 46 T.C. 392 (1966), *acq.* although in one case the unreasonableness of minimum royalty payments cost the taxpayer the case. See *Granberg Equipment Co.*, 11 T.C. 696 (1948).

6. Establishing or maintaining a market.

A. Treas. Reg. § 1.482-2(e)(2)(iv) contains a special provision that permits intercompany sales prices to be reduced for the purpose of "establishing or maintaining a market". The "intangibles" regulations do not contain a similar provision, although it would seem that such a provision is implicit in the concept of "arm's length" dealings.

B. In *Roy J. Champayne*, 26 T.C. 634 (1956), *acq.*, the Tax Court considered a related-party license agreement that provided for lower royalties during a five-year start-up period. The Court stated:

"The evidence shows also that there was a good business reason for the lower, graduated rates under this agreement during its first 5 years, namely, a forbearance on Champayne's part to enable National to become financially established."

C. Similar provisions were set forth in the agreements considered in other cases:
- In *The Nestle Co.*, 22 T.C.M. 46 (1963), the agreement provided for a royalty-free experimental period.
- In *Differential Steel Car Co.*, 16 T.C. 413 (1951), *acq.*, the agreement contained an "undue hardship" provision which the Court described as having a "legitimate business purpose."
- Other cases involved a reduction of the related-party royalty rate during a period of hardship, *John T. Potter*, 27 T.C. 200 (1956), *acq.*, and an arrangement where the licensee had royalty-free use of a patent until its value could be determined. *Heatbath Corp.*, 14 T.C. 332 (1950), *acq.*

D. Thus, it would appear that business circumstances can justify something akin to the "establish or maintain a market" concept. See also Conference Board Report, at 38.

7. Local value of trademark.

A. The most significant case to date concerning trademarks and arm's length dealings was *Your Host Inc.*[3] The Service had made a net income allocation in *Your Host* and specific charges were not in issue. Nevertheless, the Tax Court distinguished an earlier net income allocation case, *Marc's Big Boy-Prospect Inc.*, 52 T.C. 1073 (1969) *acq.*, *aff'd sub nom.*, *Wisconsin Big Boy Corp. v. Commissioner*, 452 F.2d 137 (7th Cir. 1971), by relying somewhat heavily on the difference in the taxpayers' trademarks. The Court stated:

"We believe that the Your Host trademark had little value in addition to the goodwill generated from the operation of the restaurants themselves. The Your Host trademark cannot be compared to the Big Boy trademark in *Marc's Big Boy* which was used nationally and which permitted the Milwaukee area restaurants to benefit from the goodwill generated by others across the country . . . Without doubt there was an advantage to being a Your Host Restaurant rather than another short-order cafe; however, we feel that this advantage flowed primarily from the local advertising and management shared by all of the corporations. We have already determined that the corporations divided up these items equitably. The near failure of the Rochester Your Host Restaurant, which had absentee management problems, indicated that without concentrated local advertising and local management the Your Host name was not worth a great deal." 58 T.C. at 27-28.

B. The *Your Host* case supports the proposition that trademarks may have "local" value that could preclude, or substantially reduce, a proposed § 482 allocation for the "use" of a trademark. The key would seem to be whether the "local" corporation "trades upon goodwill generated by the [parent corporation][4]" or whether it generates its own goodwill through local advertising or other means.

C. In a sense, the local subsidiary whose expenditures and operations have increased the "local" value of a trademark might be viewed as the "developer" referred to in Treas. Reg. § 1.482-2(d)(1). However, this provision presumably was intended to cover technical research and development work. If the local subsidiary is not the "developer," set-off relief should be available under Treas. Reg.

3. *Your Host Inc.*, 58 T.C. 10 (1972), *aff'd*, 489 F.2d 857 (2d Cir. 1973), *cert. denied*, 419 U.S. 829 (1974). Trademarks were involved in *Magee-Hale Park-O-Meter Co.*, supra, 15 T.C.M. at 258; *United States Mineral Products Co.*, supra, 52 T.C. at 188, 192 and 196; and *The Nestle Company Inc.*, supra, 22 T.C.M. at 49, 57 and 63 (also trade name). The "triangular dividend" issue in *The R.T. French Co.*, supra, arose from an allocation of the "free use" of "trademarks, patents, know-how, etc." The allocation, which the taxpayer was not contesting, was based on percentages of sales. See 60 T.C. at 848. International trademark licensing by U.S. manufacturing concerns, however, plays a minor role when compared with patent and know-how licensing. See Lightman, "Comparative Income Roles of U.S. Industrial Rights Abroad," 14 *Idea* 352 (1970) and Lightman "Compensation Patterns in U.S. Foreign Licensing," 14 *Idea* 1 (1970).

4. See 58 T.C. 27. Cf. *Ranier Brewing Company*, 7 T.C. 162 (1946), *acq. in part and nonacq. in part*, *aff'd*, 165 F.2d 217 (9th Cir. 1948), *rehearing denied*, 166 F.2d 324; and *Seattle Brewing and Malting Co.*, 6 T.C. 856 (1946), *aff'd*, 165 F.2d 216 (9th Cir. 1948), *rehearing denied*, 166 F.2d 326, with regard to the interrelationship of trade names and trademarks and goodwill. See also 15 U.S.C. § 1060 (1970): a trademark should be sold only with the goodwill associated with it.

§ 1.482-2(d)(1)(ii)(b) for the subsidiary's advertising and other trademark-related expenditures. Perhaps cost-sharing concepts, considered infra, are applicable.

D. The IRS has ruled that a royalty will not be imputed where a related corporation purchases trademarked goods from the owner of the trademark. Rev. Rul. 75-254, 1975-1 C.B. 243. The purchaser of trademarked goods has an implied license to resell them without paying additional compensation. Ownership of the trademark should be reflected in the goods' sales price. See also Simon, "Section 482 Allocations," 46 *Taxes* 254, 274, n. 42 (1968) (a report by the Committee on International Taxation of the New York State Bar Association); *Johnson Bronze Co.*, 24 T.C.M. 1542 (1965); and Treas. Reg. § 1.482-2(e).

8. Reciprocal consideration.

A. Treas. Reg. § 1.482-2(d)(2)(i) specifically permits the use of reciprocal rights to serve as consideration.

B. Only one of the cases discussed above involved a continuing two-way exchange of know-how and the effect of the parties' reciprocal rights on the royalty rate was not discussed by the court. See *The R.T. French Co.*, 60 T.C. 836 (1973).

C. TAM 8002001, supplemented, TAM 8002014, focused on a reciprocal licensing arrangement that provided for the exchange of research information and results as well as for the geographically divided ownership of research results. It was held to qualify as a reciprocal licensing agreement, the bona fides of which (i.e. arm's length nature of the reciprocal consideration) were to be tested based on facts in existence when it was entered into (See *The R.T.French Co.*, 60 T.C. 836 (1973), except that an annual termination provision necessitated periodic review to test the bona fides of the agreement (i.e. would unrelated parties have cancelled or renegotiated the agreement?). Factors relevant in valuing the reciprocal consideration were discussed.

D. Reciprocal rights have grown in importance with the substantial increase in research and development expenditures by foreign subsidiaries of U.S.-based multinational corporations that took place in the past 15 years. See generally, Creamer, Apostolides and Wang, "Overseas Research and Development By United States Multinationals: 1966-75 Estimates of Expenditures and a Statistical Profile," Conference Board Report No. 685 (1976). The Report indicated that nearly two-thirds of U.S. foreign R&D is performed in Germany, the U.K. and Canada. It is concentrated to a lesser extent in France, the Netherlands, Belgium and Italy.

E. The IRS argued in *Ciba-Geigy Corp.*, 85 T.C. No. 11 (1985), that the U.S. subsidiary (the taxpayer-licensee) and its Swiss parent jointly developed the intangible property, but failed to prove joint development. The Service contended that a joint development effort should be implied from the parties' "course of conduct."[5] Although rejecting the Service's argument (The court found that the Swiss parent was the "developer"), the court allocated service income to the U.S. subsidiary to compensate it for services rendered to its Swiss parent in connection with parallel screening, but not with respect to registration in the U.S. and field testing, because an un-related licensee would have performed these services for free.

9. H.R. 3838, the "Tax Reform Act of 1985."

A. As noted above, H.R. 3838 would amend § 367(d) (and have similar rules apply for purposes of § 482) to require that amounts taken into income for the transfer of intangibles be "commensurate with the income attributable to the intangible".

B. Although the revenue estimates for this provision are very small (only $16 million for 1986 [excluding Puerto Rico], for example) its reach could be extremely broad, if enacted. The House Committee Report states (at 426) that although "the bill does not mandate the use of contract manufacturer" or "cost-plus" status . . . the profit or income stream generated by or associated with intangible property is to be given primary weight."

C. The proposed new rule would apply when intangibles are transferred, licensed or "otherwise used" by a related foreign entity. Committee Report at 426.

D. The proposed new rule is, in my view, extremely ill-advised. It could wreak havoc in the area of § 482, leading to major uncertainty and substantial litigation.

10. Summary.

A. In considering the comparability of an unrelated-party licensing transaction, numerous differences may be relevant: liaison and technical services provided by the licensor and by the licensee may be significantly different in value and in importance; governmental regulation, local taxes, and the local competitive situations differ from country to country; competitor's products also might be sold by the unrelated licensee thereby enabling it to spread its marketing costs; feedback of marketing and technical information from the related licensee could be of great significance; negotiated transactions often depend upon the relative bargaining strengths of the party as well as anticipated sales volumes; the products may be different; and the state of development of the market may differ. Also, the increased risk of disclosure in an unrelated-party transaction can be significant in determining royalty rates.

5. Interestingly, TAM 7704079940A states, "cooperation in carrying on research and development programs is not the same as participation in the sharing of the cost of carrying on such programs".

B. In any event, the best support in establishing or defending an intercompany royalty rate is evidence that the same or a reasonably similar rate was charged by the taxpayer to unrelated parties or vice versa. "Expert's" views also can be helpful in establishing royalty rates.

C. Rates charged in third-party-to-third-party transactions are rarely used in making intangibles allocations. Cf. Treasury Department News Release, 8 January 1973, 1973 CCH Standard Federal Tax Reporter ¶ 6419, esp. Table 10 and the explanation thereof in § 5(c) of the "Highlights." Lightman's study, supra, indicated there are "wide variations intra-industrywise" in royalty rate ranges. See 14 *Idea* at 19, and that "little consistency was apparent on a company-by-company basis, even in the same industry" with regard to the percentage of income attributable individually to patents and to know-how. See 14 *Idea* at 365.

IV. THE INTERRELATIONSHIP OF PAYMENTS FOR INTANGIBLE PROPERTY AND TECHNICAL SERVICES

1. Transactions involving the transfer or use of intangible property (such as know-how) frequently involve the rendition of services. In some transactions, technical assistance accompanies or facilitates transfer of the intangible property while others involve continuing technical services. It may be important to determine if an allocation or a charge constitutes a royalty or compensation for services: § 861 sets forth significantly different "source" rules for royalty income from those for service income;[6] the related licensee's deduction might be affected by the characterization of an intercompany charge or allocation; withholding rates might differ depending upon characterization; and Treas. Reg. § 1.482-2(b), which covers "service" allocations, may call for a different allocation."[7]

2. IRS views.

A. Treas. Reg. § 1.482-2(b)(8) provides that where services are rendered "in connection with" the transfer of intangible property, the amount allocated is determined under the "intangibles" regulations, i.e. the value of the services should be "built into" the royalty.
- Treas. Reg. § 1.482-2(b)(8) further provides that services are rendered "in connection with" the transfer of property where such services are merely *ancillary and subsidiary* to the transfer or to the commencement of effective use of the property by the transferee.
- The regulation sets forth examples of services that "could be" ancillary and subsidiary to the transfer of intangible property: start-up assistance, performance under a start-up guarantee, supervising integration of a new process into a manufacturing operation and demonstrating and explaining the use of the property.
- Treas. Reg. § 1.482-2(b)(8) provides that continuing services that are rendered after the start-up or integration phase call for a separate "services" allocation or change.

B. *Rev. Rul. 64-56,* 1964-1 C.B. 113, which sets forth the Service's views on when know-how constitutes property for purposes of § 351, contains the same examples of ancillary and subsidiary services as does Treas. Reg. § 1.482-2(b)(8). The ruling also contains the following examples of (and comments regarding) services that the IRS views as not, or possibly not, ancillary and subsidiary to a transfer:
- Training the transferee's employees in a recognized profession, craft, or trade is distinguished as essentially educational. However, where the transferee's employees already have the particular skills in question, it ordinarily follows as a matter of fact that other consideration [presumably know-how] and not training in those skills is being furnished.
- Continuing technical assistance after the start-up phase is not regarded as performance under a guarantee. The consideration for the assistance is ordinarily treated as compensation for services.
- Assistance in the construction of a plant building to house machinery or for use in applying a patented or other process or formula which qualifies as property transferred, is ordinarily in the nature of an architect's or construction engineer's services rendered to the transferee and is not merely rendered on behalf of the transferor in producing or promoting the sale of the things transferred.
- Advice as to the layout of plant machinery and equipment may be so unrelated to the particular property transferred as to constitute no more than a rendering of advisory services to the transferee.
- When the information transferred has been developed specifically for the transferee, compensation received for the information may be treated as payment for services rendered.

3. Training employees.

A. Training of the transferee's employees might properly be characterized as services that are not ancillary and subsidiary to the transfer of intangible property. There is some support for this characterization in case law, although it is not strong support. See *Kimble Glass Company,* 9 T.C. 183 (1947), *acq.*, and *C.A. Norgren Co. v. United States,* 268 F. Supp. 816, 824 (D. Col. 1967). In *Kimble Glass,* the services characterization was not squarely in

6. Compare § 861(a)(3) with 861(a)(4) and see § 871(e). See also Rev. Rul. 55-17, 1955-1 C.B. 388, requiring an allocation between royalties and services for purposes of United States withholding taxes on remittances to a foreign licensor, and Rev. Rul. 68-443, 1968-2 C.B. 304, with regard to the source of trademark royalty income.

7. See Treas. Reg. §§ 1.482-2(b)(3) and 1.482-2(b)(7). Treas. Reg. §§ 1.482-2(b)(7)(iii) and (v) examples 11, 12 and 13 indicate that intangible property may have a significant effect upon the amount of a service charge or allocation.

issue, and in any event the Court's holding would have been the same had it ignored the services element. In *Norgren,* the Court felt that "several of the obligations undertaken by plaintiff *might* be classified as services, e.g. the schooling in Denver of Shipston representatives on the manufacture and use of the Norgren devices." It therefore reserved until the time of trial (the case was reported on a motion for summary judgment) the determination of what portion of the royalties, if any, should be characterized as services.

B. In any event, to the extent that the "training" amounts to no more than a transfer of know-how, it should not be characterized as the rendition of services. See *E.I. DuPont de Nemours and Co. v. United States,* 228 F.2d 904 (Ct. Cl. 1961); *Wall Products, Inc.,* 11 T.C. 51 (1948), *acq.;* and *United States Mineral Products Co.,* 52 T.C. 177 (1969), *acq.*

4. Continuing services and information.

A. The *Ruge* case:
- The phrase "continuing technical assistance after the start-up phase" requires some analysis. The distinction is not quite as simple as "start-up assistance" vs. "continuing assistance." Start-up, or integration assistance, might require some continuing assistance. In the leading case, *Arthur C. Ruge,* 26 T.C. 138 (1956), *acq.,* the taxpayer and his co-investor sold a patent covering electrical strain gages. They also agreed:
  (a) to furnish up to 60 days of consulting services per year to assist the buyer in the "establishment, or subsequent control, of its manufacturing operations of electrical strain gages or applications thereof or of rendering consulting services relating to or embodying strain responsive apparatus," and
  (b) to give their "best efforts and thoughts for promoting the strain gage business."
- The consulting services referred to in the first provision were held to be ancillary and subsidiary to the patent assignments because they were "of the type and kind usually called for to implement the sale of highly technical and intricate inventions." The services described in the second provision were held properly to be characterized as services as they were not ancillary and subsidiary to the transfer.

B. The *Hessert case.*
- *In Raymond M. Hessert,* 6 T.C.M. 1190 (1947), the taxpayer transferred certain intangible property and in connection therewith, agreed to
  "assist the Company by counsel, advice, consultation and other like ways in familiarizing the Company with the problems and methods of handling this particular type of business . . ."
- The Court held that "[s]uch personal services as are contemplated by the agreement strike us as ancillary and subsidiary to the sale of the patents. The services called for are of an advisory nature not unusually involved in the sale of a highly technical and intricate device."

C. The *United States Minerals* case.
- Lastly, in *United States Mineral Products Co.,* 52 T.C. 177 (1969), *acq.,* material contained in manuals that dealt principally with sales, cost estimating, and application techniques, i.e. non-secret but valuable marketing information, was transferred in connection with other highly technical information, formulas, and patents.
- The Court stated "assuming arguendo that this information was tantamount to consulting services, as [the Service] contends, we find that it was of the type usually called for to implement the sale of highly technical inventions, and, thus, was ancillary and subsidiary to the assignments of the formulas and the patent applications."[8]

D. Summary. These cases held that the "usual" type of services called for "to implement the transfer" of highly technical intangible property qualified as ancillary and subsidiary to the transfer. If the services in these cases are viewed as those rendered in a "start-up" or "implementation" phase, then such a phase may be a continuing one. Also, such a phase may involve the "establishment or subsequent control of manufacturing operations" and "familiarizing the transferee with problems and methods of handling the particular type of business." To qualify as ancillary and subsidiary, however, the services must relate to the particular intangible property transferred and not to the general advancement of the transferee's business.

E. Technical *information distinguished.*
- The continuing flow of technical *information* of a related or similar nature such as new developments in the field is to be distinguished from continuing technical *assistance.* As stated in *James C. Hamrick,* 43 T.C. 21 (1964) *acq., vac'd and rem'd on joint motion,* 66-1 U.S.T.C. ¶ 9322 (4th Cir. 1965): "[i]t is an established practice in patent assignment to provide for the assignment of future improvements and similar inventions by the assignor in order to protect the assignee from having his acquisition made worthless by reason of such improvements . . . This is not construed as a contract for services."
- Accordingly, courts that have considered agreements providing for the transfer of patents, know-how, and "future patent rights and technical data relating to the same product" have held that the after-acquired technology

8. But see *L. Schepp Co.,* 25 B.T.A. 419 (1932), *acq.,* with regard to "selling ideas". The Board held there that the taxpayer had no property right in his "selling idea."

was an incident of the existing patents and technology transferred under the agreement. *Kronner v. United States,* 110 F. Supp. 730 (Ct. Cl. 1953); *PPG Industries, Inc.*, 55 T.C. 928, 1015-1016 (1970); *United States Mineral Products Co.*, 52 T.C. 177 at 189 and 199 (1969), *acq.;* and *The Heil Co., 38 T.C. 989, 993, 1002 and 1003 (1962), acq.;* See also *E.I. DuPont de Nemours Co. v. United States,* 432 F.2d 1052 at 1057 (3d Cir. 1970); *Bell Intercontinental Corporation v. United States,* 381 F.2d 1004 at 1020 (Ct. Cl. 1967); and *Howard S. Gable,* 33 T.C.M. 1427 at 1433 (1974).

– Thus, the providing of related technical information on a continuing basis is not viewed by the courts as the rendition of services.

5. Plant and equipment assistance.

A. With regard to plant and equipment assistance, the Tax Court held in *The Heil Company,* 38 T.C. 989 (1962), *acq.*, that "the transfer of engineering and manufacturing information, or know-how, pertinent and necessary to the successful manufacture of products under the patents. . : was an incident of the patents." The engineering know-how included: "all general and detailed engineering drawings, drawings of jigs and fixtures and of special tools, specifications of materials and heat treatment [and] engineering lists . . ."

B. The transferor also had agreed to render technical engineering assistance at its Milwaukee plant without additional compensation, although additional compensation would be required for technical engineering assistance rendered elsewhere. Thus, "engineering know-how and engineering assistance in the equipping of [a] plant" have been held to be "incident[s] of patents," i.e. ancillary and subsidiary to their transfer.

6. Specifically developed information.

The Service's pronouncement concerning "specifically developed information" presumably derives from the "hired to invent" line of cases"[9] and, as such finds support in the case law. However, "hired to invent" cases are purely factual and an examination is necessary to determine whether the payments are attributable to the transfer of patent rights or whether they represent compensation for services. These cases would seem to support a services characterization if the invention did not exist or was clearly in an embryonic stage and the services were rendered in creating or further developing the invention.

7. Supervision of manufacturing.

Treas. Reg. § 1.482-2(b)(8)'s statement regarding the supervision of manufacturing operations finds some support in the case law. In two older cases, compensation for this type of activity was held to constitute compensation for services instead of royalty income. *U.S. Universal Joints Company,* 46 B.T.A. 111 (1942) and *Anton Dolenz,* 41 B.T.A. 1091 (1940).

8. Royalty vs. service.

A. The courts have shown a great reluctance to allocate a portion of royalty income to compensation for services unless there was some clear basis for making such an allocation. One of the very few cases in which the taxpayer successfully argued that it should not be bound by the contractual designation of the payments as "royalties" was *U.S. Universal Joints Company,* 46 B.T.A. 111 (1942). See also *Anton Dolenz,* 41 B.T.A. 1091 (1940). At the time the agreements in this case were executed, it was understood and agreed by the parties that substantial services would be rendered by the taxpayer. They found it impossible to draft a contractual provision that would clearly outline their respective rights and duties with regard to these services. Thus, no express provision for such services was made in the agreements. Taxpayers who desire a services categorization should make a clear provision for services income in the agreement.

B. Most taxpayers were not as fortunate as the taxpayer in *U.S. Universal Joints.* See *Lane-Wells Co. v. Commissioner,* 134 F.2d 977 (9th Cir. 1943), *cert. den.*, 320 U.S. 741 (1943), *aff'd on another issue,* 321 U.S. 219 (1944); *Packers Development Corp.*, 26 T.C.M. 932 (1967); *John C. O'Connor,* 16 T.C.M. 213 (1957), *aff'd on another issue,* 260 F.2d 358 (6th Cir. 1958) *cert. den.*, 359 U.S. 910; *Precious Metals Developing Co., Inc.*, 15 T.C.M. 1200 (1956); and *Warren Browne, Inc.*, 14 T.C. 1056 (1950).

C. The Service also has argued unsuccessfully in a number of cases that an allocation should be made to service income. See *E.I. DuPont de Nemours and Company v. United States,* 432 F.2d 1052 at 1057 (3d Cir. 1970); *The Heil Co.* 38 T.C. 989 (1962), *acq.; Arthur C. Ruge,* 26 T.C. 138 (1956), *acq., Raymond M. Hessert,* 6 T.C.M. 1190 (1947); and *James C. Hamrick,* 43 T.C. 21 (1964), *acq.; vac'd and rem'd on joint motion,* 66-1 U.S.T.C. ¶ 9322 (4th Cir. 1965).

D. The courts have made an allocation to service income where there was a clear basis for doing so. For example, courts have been amenable to making an allocation where the royalty rate would be reduced by a fixed percentage should the taxpayer terminate his employment. See Spence v. United States, 156 F. Supp. 556 (Ct. Cl. 1957), and *William R. Ost,* 17 T.C.M. 80 (1958). Additionally, two district courts ordered a trial and a second trial respectively to determine whether an allocation

9. See *Melin v. United States,* 478 F.2d 1210 (Ct. Cl. 1973); *Howard S. Gable,* 33 T.C.M. 1427 (1974); and *Roland Chilton,* 40 T.C. 552 (1963) *acq.;* holding that the taxpayer was not "hired to invent;" and see *Estelle Goldman,* 34 T.C.M. 639 (1975); *William T. Downs,* 49 T.C. 533 (1968), *acq., Karl R. Komarek,* 26 T.C.M. 523 (1967); and *Arthur N. Blum,* 11 T.C. 101 (1948), *acq., aff'd,* 183 F.2d 281 (3d Cir. 1950); holding that the taxpayer was "hired to invent", in which case the taxpayer was in receipt of compensation for services rendered. "Hired to invent," however, itself may be a misnomer. See *William F. Beausoleil,* 66 T.C. 244 (1976).

was necessary or how much should be allocated, but no further proceedings were reported. *C.A. Norgren Co. v. United States,* 268 F. Supp. 816 (D. Col. 1967); and *Armco Steel Corporation v. United States,* 263 F. Supp. 749 (S.D. Ohio 1966).

E. Lastly, the obvious should not go unmentioned. If services are rendered but here is no "transfer" of an intangible asset, there should be no charge or allocation under Treas. Reg. § 1.482-2(d), although a services charge or allocation may be in order under Treas. Reg. § 1.482-2(b).

V. CONVEYANCES

1. Sale.

A. Know-how, patents and other intangibles can be sold instead of being licensed. Capital gains may result, but other tax results also follow from the sale characterization.

B. The first issue that must be addressed is whether the know-how constitutes "property" for purposes of the capital gains rules.
   - Rev. Rul. 64-56, 1964-1 C.B. 133, considered in Section IV supra, sets forth the IRS' views with respect to what is necessary for know-how to constitute "property."
   - The IRS' views on know-how represent a significantly narrower definitional interpretation of the "property" requirement than has been expressed by the courts, as discussed in Section IV above.

C. "All substantial rights" must be conveyed to obtain capital gains treatment. See *Pickren v. United States,* 378 F.2d 595 (5th Cir. 1967); *E.I. DuPont de Nemours & Co. v. United States,* 288 F.2d 904 (Ct. Cl. 1961); and *Taylor-Winfield Corp.,* 57 T.C. 205 (1971).
   - Generally, the exclusive right to "make, use and sell" products using the patents or know-how within all the territory of at least one country must be conveyed for gain on the sale of patents or know-how to qualify as capital gain.
   - Numerous exceptions exist that must be weighed on an aggregate basis to see whether substantial rights have been retained. See *E.I. DuPont de Nemours & Co. v. United States,* 432 F.2d 1052 (3d Cir. 1970).
   - For example, the courts and the IRS generally permit a security interest in the nature of a condition subsequent to be retained where ownership of the intangible property will revert to the transferor should the transferee stop making the required payments of the purchase price. "Best efforts" and insolvency clauses also generally are permitted. See *Bell Intercontinental Corp. v. United States,* 381 F.2d 1004 (Ct. Cl. 1967); *Kronner v. United States,* 110 F. Supp. 730 (Ct. Cl. 1953); *Golconda Corp.,* 29 T.C. 506 (1957), *acq.; Leonard Coplin,* 28 T.C. 1189 (1957), *acq.;* See also Treas. Reg. §§ 1.1235-2(b)(2)(ii) and (3).
   - It seems reasonably clear, however, that the transferor cannot retain the power to terminate the agreement at will. See *Bell Intercontinental Corp.,* supra. Including such a provision renders the transaction a license instead of a sale.
   - Full, generally unlimited rights must be conveyed. Limitations, such as field of use restrictions, or geographic restrictions within a country, can interfere with capital gains treatment. See *Mros v. Commissioner,* 493 F.2d 813 (9th Cir. 1974); See also *Blake v. Commissioner,* 615 F.2d 731 (6th Cir. 1980) (after substantial rights were licensed, gain from the sale of the remaining, also substantial rights could not qualify under § 1235), and compare *Bell Intercontinental Corp. v. United States,* supra, at pp. 1013-1016 on this point.

D. Rights must be conveyed in perpetuity, subject to "C" above.
   - In *Pickren v. United States,* supra, income from a 25-year exclusive license could not qualify for capital gains treatments because the know-how conveyed was expected to have a life in excess of 25 years.
   - Rev. Rul. 71-564, 1971-2 C.B. 179, permits a transfer of know-how to qualify as one made in perpetuity if the right conveyed is to use the know-how until the know-how becomes public knowledge and no longer protectible under the applicable law of the country where the transferee is to operate.

E. Holding period.
   - To obtain long term capital gains treatment, the 12-month holding period requirement must be satisfied.
   - The holding period for patents and know-how begins when they are "reduced to practice." See *PPG Industries,* 55 T.C. 928 (1979): *U.S. Mineral Products Co.,* 52 T.C. 177 (1969), *acq.;* and *D. Simon,* 20 T.C.M. 1309 (1961): see also Treas. Reg. § 1.1235-2(e).

F. Other impediments to obtaining capital gains treatment.
   - § 1249, if the sale is to a foreign subsidiary. See LTR 8038048 holding that a right of first refusal does not constitute an option in the case of a 50-50 joint venture for this purpose.
   - § 1253. Contingent payment for intangibles covered by § 1253 can preclude capital gains treatment. § 1253(b)(2)(F).
   - § 1221(1) could apply if too many such sales are made, although there are no cases directly on point. Cf. *International Shoe Machine Corp. v. United States,* 491 F.2d 157 (1st Cir 1974).
   - The *Corn Products* doctrine conceivably could apply, although there are no cases directly on point.
   - § 1221(3) conceivably presents problems

where copyright rights exist. Query the effect here on software, which became copyrightable in late 1980? Presumably "personal efforts" cannot be viewed as creating it. Rev. Rul. 55-706, 1955-2 C.B. 300, superseded on other grounds, Rev. Rul. 62-141, 1962-2 C.B. 182.

- The service element of know-how, discussed supra, could present problems.

G. Imputed Interest. § 483 could apply. See Treas. Reg. § 1.483-1(e); but see § 483(f)(4) re patents.

H. Source of the income.[10]

(i) Royalties for the right to use intangible property abroad generally constitute foreign source income. § 861(a)(4).

(ii) The sale of know-how has been held subject to § 863(b), "income partly from within and partly from without the U.S." Rev. Rul. 71-231, 1971-1 C.B. 229. See, however, *AMP, Inc. v. United States,* 79-2 U.S.T.C. ¶ 9606 (M.D. Pa. 1979).

(iii) Title passage rules are relevant. See Rev. Rul. 71-231 where the place of sale seemed to be the place where all negotiations for the sale took place.

(iv) § 904(b)(3)(C) and its rule for resourcing foreign source capital gains also can be important.

I. Inbound technology sales may not escape U.S. withholding tax. See § 871(e); see also Rev. Rul. 80-362, 1982-2 C.B. 208.

2. § 351 – The IRS' Position.

A. Both patents and the exclusive right to use patents within one or more countries have long been considered "property" for purposes of § 351. *E.I. DuPont de Nemours and Co. v. United States,* 471 F.2d 1211, 1218 (Ct. Cl. 1973); citing *F.L.G. Straubel,* 29 B.T.A. 516, 521-522 (1933) *acq., Claude Neon Lights Inc.,* 35 B.T.A. 424 (1937), *acq. in part and nonacq. in part.*

B. The IRS' published position is that the equivalent of a "sale or exchange" under the capital gains provisions is necessary for qualification under § 351. See Rev. Rul. 69-156, 1969-1 C.B. 101. Thus, the IRS requires that "all substantial rights" be conveyed. GCMs 36922 (16 November 1976), 37178 (24 June 1977) and 38114 (27 September 1979) states that *du Pont* was correct and that the Service should follow *du Pont.* Such an announcement, however has never been made. The DEFRA Blue Book cites *Du Pont* approvingly.

C. The conveyance to a "controlled corporation" of know-how or the exclusive right to use know-how in one or more countries also can qualify as a "tax free" transaction under § 351. See Rev. Rul. 64-56, 1964-1 C.B. 113: Rev. Proc. 69-19, 1969-2 C.B. 301.[11] However, the Service has taken an unduly restrictive view as to when such transfers qualify. In addition to requiring that there be an exclusive transfer of all substantial rights in perpetuity, the IRS also requires that the know-how be *secret* and that the country in which the transferee will operate affords substantial legal protection to the transferor against the unauthorized disclosure and use of the secret know-how.

D. Other know-how representations required by Rev. Proc. 69-19:

(i) The know-how is not revealed by a patent, is not the subject of a patent application, nor is it disclosed by the product on which it is used or to which it is related.

(ii) The know-how does not represent mere knowledge, or efficiency resulting from experience, or mere skill in manipulation or total accumulated experience and skill of the transferor.

(iii) The know-how involved does not consist merely of the rights to tangible evidence of information such as blue prints, drawings or other physical material on which it is recorded.

(iv) The know-how has not been developed especially for the transferor.

(v) The know-how is not in the form of assistance in the construction of a plant building or advice as to the layout of machinery and equipment.

(vi) The know-how does not consist of training of the transferee's employees in a manner that is essentially educational in nature. And

(vii) Technical information of a related or similar nature such as new developments in the field will not be furnished on a continuing basis without adequate compensation therefor in the form of a fee negotiated at arm's length (in consideration other than stock or securities of the transferor unless such stock or securities are identified).

E. To obtain an advance ruling that the transaction qualifies under § 351, the taxpayer must state that the know-how represents "a discovery . . . [that] is original, unique and novel." The taxpayer may represent for ruling purposes that the requisite substantial legal protection is afforded under the laws of the country from which the know-how will be transferred. If such a representation is made, the Service "will consider" for ruling purposes that such protection is provided the transferor under the laws of the transferee's country.

F. The Service's published position on transfers of know-how involves a narrower interpretation of the term "property" in the context of know-how transfers than that given the term by the courts. For example, it's not clear that know-how must be secret to qualify as property under § 351. Compare *United States Minerals Products Co.,* 52 T.C. 177 (1969), *acq.,* with *E.I. DuPont de Nemours and Co. v. United States,* 288 F.2d 904 (Ct. Cl. 1961). The courts seem to be more interested in whether the know-how has *value,* see *Huckins v. United*

10. H.R. 3838, the "Tax Reform Act of 1985", would require changes in the source rules not considered here.

11. Note that these rules also apply to software transfers. Rev. Proc. 74-36, 1974-2 C.B. 491.

States, 60-1 U.S. T.C. ¶ 9394 (S.D. Fla. 1960); *United States Minerals Products Co.,* supra; and *E.I. DuPont de Nemours and Co. v. United States,* supra, although perhaps the "secretness" of the know-how is a relevant consideration in determining whether the know-how has value. In any event, "secretness" does not appear to be the sole substantive criterion. Also, the Service's position raises a number of questions: for example, what is "substantial legal protection?" And what is meant by the phrase "in the general nature of a patentable invention?"

G. The Service's position with regard to the transfer of trademarks and trade names to a "controlled corporation" apparently is similar to its positions on patents and know-how, i.e. that the exclusive right to use the trademark or trade name in one or more countries must be transferred in perpetuity. See Rev. Proc. 73-10, 1973-1 C.B. 760 § 3.02(5), superseded by Rev. Proc. 83-59, I.R.B. 1983-33 (which isn't as clear as Rev. Proc. 73-10 on this point), and Rev. Rul. 79-288, 1979-2 C.B. 139. Also, all substantial rights in the trademark or trade name in that country or those countries must be transferred. Issues can arise here under Rev. Proc. 69-23, 1968-1 C.B. 821, if § 367 is involved (see below).

H. The IRS National Office took the position in TAM 8040019 that the transfer of know-how and trademarks to a § 931 (now § 936) subsidiary via § 351 would not permit the income earned by these income producing functions (i.e. the intangible income-producing assets) to be earned by the § 931 (now § 936) subsidiaries and that apparently an intercompany pricing adjustment was necessary. In *Eli Lilly & Co.* 85 T.C. No. 65 (1985), the subsidiary-transferee was respected as the owner of a patent transferred under § 351. However, the court also found an income distortion, stating, "it is inconceivable that petitioner, negotiating at arm's length, would have transferred valuable income-producing intangibles without a royalty, lump-sum payment, or other agreement that would enable petitioner to continue its general research and development activities." Interestingly, the IRS issued a favorable § 351 ruling on this issue after it initially took the position on audit that such intangibles couldn't be so transferred or that such a transfer won't be respected for transfer pricing purposes. See LTR 7837028, involving formulas, processes, trade secrets and trademarks. TEFRA, of course, has changed the § 936 pricing rules for future years.

I. LTR 8035086 involved the § 351-§ 367 transfer of manufacturing know-how to a foreign subsidiary. The U.S. parent wanted to retain the right to sell its U.S. manufactured goods in that country. Interestingly, the IRS offered to issue the requested § 367 ruling using a 10% de minimis test in this regard, but the taxpayer declined to accept this proposal and the § 367 ruling was issued unfavorably. The IRS stated near the end of the ruling that in any event retention of the "right to sell" could constitute the retention of a substantial right that would preclude application of § 351. See also LTR 8128049, *rev'g* LTR 8035086, but questioning applicability of § 351. Nevertheless, similar representations were contained in other rulings. See, *e.g.,* LTRS 8023115, 8038039 and 8134193. LTRS 8024178 and 8029031 involved an additional 10% representation concerning a limitation on U.S.-made components. Compare LTR 8238061 which seemed to allow a retained right to sell in the covered territory.

3. § 351 – The *Zachry* and *DuPont* cases.

A. The leading cases in considering whether the transfer to a controlled corporation of less than "all substantial rights" in an intangible asset can qualify as a "tax free" transaction for purposes of § 351 are *H.B. Zachry Company,* 49 T.C. 73 (1967), and *E.I. DuPont de Nemours and Company v. United States,* 471 F.2d 1211 (Ct. Cl. 1973); *See also United States v. Stafford,* 727 F.2d 1043 (11th Cir. 1984).

B. In *Zachry,* the Tax Court, in an opinion that was reviewed by the Court without any dissents, held that a carved-out oil payment constituted "property" for purposes of § 351, noting:

"§ 351 does not contain a definition of the term 'property'. However, the known inclusions and exclusions strongly suggest that the term encompasses whatever may be transferred. Significantly, 'services' are explicitly excepted by sec. 351(a). Such a singular and extraordinary exception denotes the scope of the term 'property' under the rule of statutory construction – *expressio unius est exclusio alterius."*

C. *DuPont* involved the conveyance of a *non-exclusive* license to make, use, and sell certain products in France. The license was royalty-free, prohibited sublicensing without consent (for the most part), and was to run for the remaining life of the patents. The Court held that the transfer qualified as a conveyance of "property" within the meaning of § 351. The Court rejected the government's argument, as had the Tax Court in *Zachry,* that § 351 requires a transaction that would qualify the exchange for capital gains purposes. Quoting from *Zachry,* the Court stated:

"Unlike 'the problem of capital gain versus ordinary income', section 351 is 'concerned solely with the historic exemption of transfers of a controlled corporation where the taxpayer's interest in the property continues although the form of ownership is changed'."

The Court stated that *Zachry's* carved-out oil payment was "quite comparable to a non-exclusive license" and noted that the government "appears to acknowledge *Zachry* as very close on its facts to the present case . . ."

D. The *Zachry* and *DuPont* cases went further than the IRS thus far has indicated that it is willing to go in permitting transfers to qualify under § 351. The IRS has neither acquiesced nor nonacquiesced in *Zachry* and it was willing to relitigate the issue 6 years later in *DuPont*. Nevertheless, these cases held the § 351 standards to be significantly different from those necessary to qualify a transaction for capital gains treatment.

E. GCMs 36922 (16 November 1976), 37178 (24 June 1977) and 38114 (27 September 1979) stated that *Du Pont* was correct and that the Service should follow *Du Pont*. Such an announcement, however, has never been made. The DEFRA Blue Book cites *Du Pont* approvingly.

4. § 367 (before 1985: DEFRA).

A. If the § 351 transaction will involve the transfer by a domestic corporation to a foreign corporation, it is necessary to obtain a ruling under § 367. Rev. Proc. 68-23, 1968-1 C.B. 821, provides that a favorable ruling ordinarily will be issued where the transferee foreign corporation will use the property in the active conduct of a trade or business in a foreign country. It further provides that the transferee foreign corporation should have a need for a substantial investment in fixed assets in such business or should be engaged in the purchase and sale abroad of manufactured goods.

B. Rev. Proc. 68-23 imposes additional requirements when intangible property will be transferred. It provides that an advance ruling generally will not be issued if:
- the transferor is a licensor of the property at the time of transfer, unless the transferee corporation is the licensee,
- circumstances make it reasonable to believe that the property will be licensed by the transferee corporation after the transfer,
- the property consists of United States patents, trademarks or similar intangibles to be used in connection with (a) conduct of a trade or business in the United States or (b) the manufacture in the United States or a foreign country of goods for sale or consumption in the United States, or
- the property consists of foreign patents, trademarks or similar intangibles to be used in connection with the sale of goods manufactured in the United States.

C. Rev. Proc. 68-23 also provides that a favorable ruling will not be issued if certain other types of property will be transferred by a domestic corporation to a foreign corporation. Although generally the list is not intangibles-oriented one of the enumerated, prohibited properties is § 1221(3) property (copyrights). Query software, especially after 1980 U.S. legislation specifically making it copyrightable? Is § 1221(3) incorporated in full, that is, must personal efforts be involved or is it the fact that it's copyrightable?

D. Rev. Rul. 79-288, 1979-2 C.B. 139, held that other assets may have to be covered in a § 367 ruling request: trade names, going concern value and goodwill, at least where they rise to the level of "property." Note that the transfers in Rev. Rul. 79-288 were to foreign subsidiaries that anticipated establishing manufacturing operations. The IRS' National Office has expressed the view that the value of assets such as these must be taken into income as a "toll charge" to obtain a § 367 ruling for the transfer of assets to a foreign marketing subsidiary that will sell U.S. manufactured goods. But see LTR 8146044 permitting such a transfer if the proper representation is made (interestingly, it took a year to get the ruling). Subsequent rulings have followed LTR 8146044.

E. Omitting an asset from the § 367 request could have resulted in an invalid ruling under pre-DEFRA § 367(a). See Temp. Reg. § 7.367(a)-1(f)(3) and Rev. Rul. 76-333, 1976-2 C.B. 104.
- LTR 7917119, for example, thus listed among the assets to be transferred goodwill, going concern value, real and personal property leases and agreements with suppliers and distributors. LTR 8243047 added "order backlog" to the list.
- LTR 8016029 involved a request that a § 367 ruling include "the trademark W and Name Y (if it is subsequently determined that use by Y of trademark W and/or the trade name Y is a transfer of property from X to Y)." The request was granted, but the IRS expressed no opinion as to whether the use of those items constituted a transfer.

5. § 1491 (before 1985: DEFRA).

A. Transfer to a foreign partnership or joint venture required (pre-DEFRA) that a § 1492 ruling be obtained unless later relief under § 1494 will serve as the foundation necessary to avoid § 1491.

B. This involved entering into a closing agreement. See LTRs 7948081 and 8009109.

6. DEFRA's changes to §§ 367 and 1491.

A. DEFRA substantially changed § 367(a). § 6038B requires IRS notification of § 367(a) transactions, subject to a heavy penalty for failure to comply.

B. Revised § 367(a) permits certain categories of assets to be transferred, such as certain stock and certain property used in the active conduct of a trade or business; it codifies Rev. Rul. 78-201, 1978-1 C.B. 91 (loss recapture), Rev. Rul. 81-4, 1981-1 C.B. 128 (taxing the transfer of appreciated foreign currency) and, in part, Rev. Proc. 68-23, 1968-1 C.B. 821 (§ 367 ruling guidelines); and, most importantly, it bars the tax-free transfer abroad of intangible property (except as permitted in regulations).

C. Tax-free transfers abroad of intangible property (within the meaning of § 936(h)(3)(B) not only is barred (except as provided in regulations), the proposed new rule imputes a contingent sales price that is treated as U.S. source income.

- Query whether licensing – and not transferring – would permit the royalty to retain its characterization as foreign source income? This could become important.
- Cost sharing also may become more important.
- Marketing intangibles (goodwill, going concern value, trademarks, trade names, etc.) may still be transferred in appropriate cases states the Senate Report (p. 365). The House Report (pp. 1317 and 1320; but see p. 1324) refers only to goodwill and going concern value in this respect.
- The Senate Report (p. 368) states that these special rules (including the sourcing rule) would have no application to § 482 adjustments.
- The DEFRA Blue Book cites *Du Pont, supra,* approvingly. This could be important. See Section V.2B and 3E.

D. §§ 1492 and 1494 (re transfers to foreign partnerships, etc.) were changed accordingly.

E. These new rules are effective with respect to transfers or exchanges after 31 December 1984.

7. H.R. 3838.

A. H.R. 3838, the "Tax Reform Act of 1985," was discussed in Section III, primarily in III.9.

B. It could have a major impact on the DEFRA § 367 rules insofar as the amount involved is concerned.

8. § 1031. The transfer of intangible property under § 1031, assuming that it otherwise qualifies under § 1031, presumably also gives rise to similar problems with respect to issues such as those involved in Rev. Rul. 64-56, supra.

VI. COST-SHARING

1. Cost-sharing agreements are permitted under Treas. Reg. § 482-2(d)(4) (in a truncated version of the proposed version of that regulation). They are encouraged under Treas. Reg. § 1.861-8 (1977) and they are permitted under the new United States–United Kingdom income tax treaty and Canadian §§ 37(2) and 212(1)(d)(viii). See LTR 8111103, which involved cost-sharing using a French GIE (Groupement d'intérêt économique) and issues under Treas. Reg. § 1.861-8. TAM 7704079940A found that two written agreements were not cost-sharing agreements.

2. Significantly, the June 1979 OECD report on transfer pricing contains a lengthy discussion (pp. 55-62) on cost-sharing, indicating that the United States' experience with cost-sharing has been "positive."

3. Treas. Reg. § 1.482-2(d)(4) provides that "a bona fide cost-sharing agreement is an agreement, in writing, between two or more members of a group of controlled entities providing for the sharing of the costs and risks of developing intangible property in return for a specified interest in the intangible property that may be produced."

4. The 1966 proposed version of Treas. Reg. § 1.482-2(d)(4) provided that the agreement must contain provisions setting forth the nature and extent of the interest of each of the participating members in any intangible property that may be produced (including residual rights therein), it must commit all participating parties to the sharing of costs whether intangible property is in fact produced, and it must serve as the basis on which costs are shared (although some variation from the agreement was permitted). The participating member must intend to use developed property in the active conduct of its business. Cost-sharing, under that proposed regulation, could be on a project basis or could cover more than one project.

5. The 1966 proposed regulation also provided that the costs to be shared are equal to the sum of

(i) an amount equal to all the direct and indirect costs actually incurred by the parties to the agreement which are allocable in accordance with the principles of Treas. Reg. § 1.482-2(b),

(ii) any amounts allocable under § 482 (whether allocated or not) with respect to assistance rendered by members of the group who are not parties to the agreement, and

(iii) an amount equal to the arm's length value of the use of any intangible property of a party to the agreement which is made available to it for use in connection with the cost-shared activities and which is likely to contribute to a substantial extent in the production of intangible property.

6. Under that proposal, the costs and risks shared were to be those that an unrelated party would have agreed to share. Prospective benefits to be derived were important, i.e. relative anticipated benefits. Long-term cost-sharing had to be based on a standard (such as comparative current sales or profits) which reflected changing conditions. Examples indicated that, under the stated facts, sharing was permissible on the basis of past sales, current sales or forecasted sales. The main requirement on sharing was that there be a reasonable basis consistent with facts and circumstances for the cost-sharing.

7. The DEFRA (1984) Blue Book recommends expanding the regulations on cost-sharing in discussing the § 367 change.

8. The June 1979 OECD report indicated that countries other than the United States had little experience with cost-sharing arrangements. It also indicated that they, therefore, have not felt the need to draft special rules covering cost-sharing arrangements. A key policy issue, notes the report, has to do with justification of benefits to the cost-sharee. Thus, among other

things, the research would have to be closely related to the specific needs of the recipients. It also notes that normally only manufacturing enterprises would be expected to be participants since trading enterprises would expect to recover their costs in the price of goods sold, but there may be exceptions.

9. Query reciprocal cost-sharing agreements? See Tam 8002001, supplemented TAM 8002014.

10. Note that intangibles can be cost-shared. Query application of these rules to intangibles such as trademarks, etc. See LTR 7837028 which involved the transfer of trademarks to a § 936 subsidiary. The § 936 subsidiary would thereafter bear the cost of advertising. Consider also the discussion on the "Local Value of Trademarks," supra.

11. Query the effect on cost-sharing of the provisions contained in H.R. 3838, the "Tax Reform Act of 1985," discussed in Section III?

12. See TMIJ 80-4 (April 1980) for a discussion of French views on cost sharing. Note that a French withholding tax issue can arise. TMIJ 80-9 (September 1980) contains a discussion of German views.

13. Section 936(h) (TEFRA) focuses on cost-sharing.

VII. OTHER UNITED STATES TAX CONSIDERATIONS

1. Effect on intercompany pricing.

A. The Internal Revenue Manual offers considerable assistance in establishing or defending a corporate network and an intercompany pricing structure. See Manual § 600, et seq. (CCH IRM "Audit" p. 7283-27), and § 42(19)0, et seq. (CCH IRM p. 7291).

B. The Manual states that the importance of a *functional* analysis cannot be overemphasized and that virtually all § 482 cases can be reduced to the following questions:
- What was done?
- What economically significant functions were involved in doing it?
- Who performed each function?
- What is the measure of the economic value of each function performed by each party?

C. The Manual provides that frequently a "function" consists of services that must be performed by individuals.
- Accordingly, IRS auditing agents are directed to obtain information regarding how many employees were employed by each organization, the compensation paid to individual employees and the functions performed by those employees in connection with the questioned transactions.
- Agents are supposed to provide the basis for their conclusions that the individuals involved were employees of one organization rather than another. For example, this might be a reference to employment or withholding records.

D. *Significantly,* the Manual states that other *economically significant functions are performed by capital such as patents and other intangibles, capital put at risk* in carrying accounts receivable, in purchasing and using machinery, etc.

E. Thus, the Manual continues, if significant income-producing intangibles are involved, such as *valuable patents* or *well-recognized trademarks or trade names,* it is important not only to state which organization owns the intangible but also, when there is a possibility of doubt as to ownership, to identify the records or other evidence which supports the conclusion as to ownership.

F. Ownership – or disputed ownership – of intangibles can be determinative of the outcome in a § 482 intercompany pricing dispute. *See Eli Lilly & Co.,* 85 T.C. No. 65 (1985).

G. The June 1979 OECD report entitled "The Determination of Transfer Prices Between Associated Enterprises" also emphasizes a functional approach to transfer pricing. See e.g. Art. 17 of the report.

H. Income-producing intangibles can include items such as *corporate reputation.* See *Smothers v. Commissioner,* 642 F.2d 894 (5th Cir. 1981) (involving a liquidation-reincorporation), and *Hospital Corporation of America,* 81 T.C. No. 31 (1983) (reputation for "experienced and expertise"). A number of IRS audits involves IRS arguments that income producing intangibles also include or in effect include *business risk* (See also *E.I. DuPont de Nemours & Co. v. United States,* 608 F.2d 445 (Ct. Cl. 1978), *cert denied; Diefenthal v. United States,* 367 F. Supp. 506 (E.D. La. 1973), and the IRS' Economic Guide, "Economic Aspects of § 482"; *capabilities and abilities in the areas of management, marketing and service; market acceptance and penetration; the going concern value of an established organization; product quality;* and, of course, *manufacturing intangibles such as manufacturing and product know how. Concord Control,* 78 T.C. 742 (1982), is an important case dealing with "going concern value."

I. TEFRA, of course, enacted § 936(h) re possessions corporations' pricing. It focuses on marketing vs. manufacturing intangibles. The regulations could be important even for those not involved with § 936(h).

2. Subpart F.[12]

A. Royalties received by a CFC (Controlled Foreign Corporation) are generally treated as foreign per-

12. H.R. 3838, the "Tax Reform Act of 1985", would effect changes with respect to Subpart F's treatment of royalties and the treatment of royalties under § 904(d) that are not considered here.

sonal holding company income (and therefore Subpart F income) unless the royalties
- are derived in the active conduct of a trade or business and are received from unrelated persons or
- are received from a related person for the use of, or the privilege of using, property within the CFC's country of incorporation. §§ 954(c)(3)(c) and (c)(4)(c).

B. Treas. Reg. §§ 1.954-2(d)(iii)(a)(1) and (2) provide that royalties are considered derived in the active conduct of a trade or business if they are derived from the licensing of property
- which the CFC has developed, created or produced (or has acquired and added substantial value to), but only if the CFC is regularly engaged in such activity *or*
- which is licensed as a result of the performance of "marketing functions" by the licensor and licensor, through its own staff of employees located in a foreign country, maintains and operates an organization in such country which is
  (a) regularly engaged in the business of marketing (or of marketing and servicing) the licensed property and
  (b) substantial in relation to the amounts of royalties derived from the licensing of such property.

C. Without limiting the subjective test of "substantiality," Treas. Reg. § 1.954-2(d)(iii)(b)(2) provides an objective safe harbor test. A marketing organization will be deemed substantial in relation to the royalties derived if the sum of the deductions incurred by the organization which are properly allocable to the royalty income (and which would be allowable under § 162 if the CFC were a United States corporation) – other than (a) deductions for compensation for services rendered by shareholders or related persons, (b) deductions for royalties paid or accrued by the CFC and (c) deductions which would be allowable under sections other than § 162 of the Code – equals or exceeds 25% of the amount by which gross royalty income exceeds royalties paid or accrued and amounts that would be allowable under § 167.

D. Characterizing know-how as property vs. services was considered above in Section IV. It may have a service element or what appears to be know-how may constitute the rendition of service. Foreign base company services income is income of a CFC (whether received in the form of compensation, commissions, fees or otherwise) which is derived in connection with the performance of technical, managerial, engineering, architectural, scientific, skilled, industrial, commercial or like services which are performed for, or on behalf of, a "related person" and which are performed outside the country where the CFC is organized. § 954(e).

E. Treas. Reg. § 1.954-4(b)(1) indicates that the forbidden services "for, or on behalf of, a related person" include but are not limited to services performed by a CFC where
- the CFC is paid or reimbursed by, or otherwise receives substantial financial benefit from, a related person for performing such services;
- the CFC performs services which a related person is or has been obligated to perform;
- the CFC performs services with respect to property sold by a related person and the performance of such services constitutes a condition or material term of such sale; and
- substantial assistance contributing to the performance of such services has been furnished by a related person.

F. In the context of the last condition above, the regulations provide that direction, supervision, services or know-how furnished by a related person will not in themselves be considered "substantial" unless either (a) such assistance provides the CFC with skills which are a principal element in producing the income from its performance of services or (b) the cost to the CFC of such assistance equals 50% or more of the total cost to the CFC of performing the services. Treas. Reg. § 1.954-4(b)(2)(ii)(b).
- For this purpose, "cost" is determined under the "arm's length" intercompany pricing rules of § 482.
- In any event, assistance in the form of direction, supervision, services or know-how is not taken into account unless the assistance assists the CFC *directly* in the performance of the services performed by the CFC. Treas. Reg. § 1.954-4(b)(2)(ii)(e).
- Treas. Reg. § 1.954-4(b)(3) Ex. (2) indicates that lending technical or supervisory personnel to a CFC to perform its technical services could be deemed to be a principal element in producing the CFC's service income and therefore "substantial assistance" – even if the CFC only temporarily employed such personnel.
- Furthermore, any financial assistance (other than contributions to capital), equipment, material or supplies furnished to a CFC by a related person, to the extent not fairly compensated by arm's length charges, must be compared to the profits derived by the CFC from its services to determine whether such assistance is substantial. Treas. Reg. § 1.954-4(b)(2)(ii)(c).

G. In determining where services are performed, technical, managerial, engineering and other similar services are considered performed where the persons performing the services are physically located. Treas. Reg. § 1.954-4(c). In some cases an apportionment must be made between those services which are performed within the CFC's country of incorporation and those performed outside that country.

H. Classification of the income can be important. Classification of know-how vs. services was considered in Section IV above. The Subpart F rules also contain rules concerning classification.

- Income derived by a CFC from the performance of an integrated business transaction must generally be classified in accordance with the predominant characteristic of the transaction, even though a part of such income could incidentally be imputed to another class of income. Treas. Reg. § 1.954-1(b)(2).
- Thus, for example, if a CFC derives income under a contract which provides for the rental of property and also for the furnishing by the CFC of an incidental amount of maintenance services in respect of the rental property, the entire amount of the income derived under such contract is treated as rent.
- Likewise, if a CFC contracts to provide engineering services consisting of planning a project and incidental to such planning uses its own equipment, the entire income derived under the contract will be treated as derived from the performance of services.
- On the other hand, where a CFC is engaged in performing separate transactions, even though pursuant the same contract or arrangements, the income from each transaction will be separately classified. For example, if a CFC contracts to rent equipment and also to furnish engineering services consisting of planning a project, the income derived under such a contract will be treated as derived in part from rent and in part as income from the performance of services.

3. DISC (now FSC).

A. A DISC was (now a FSC is) subject to a number of very technical rules, one of which is that 95% or more of its gross receipts must consist of "qualified export receipts." Qualified export receipts include gross receipts from the lease[13] or rental of "export property," which is defined to *exclude,* inter alia: "Patents, inventions, models, designs, formulae or processes, whether or not patented, copyrights (other than films, tapes, records or similar reproductions, for commercial or home use), goodwill, trademarks, trade brands, franchises or other like property . . ." § 993(c)(2).

B. In discussing this provision, Treas. Reg. § 1.993-3(f)(3) provides:
"*Intangible property* . . . Although a copyright such as a copyright on a book does not constitute export property, a copyrighted article (such as a book) if not accompanied by a right to reproduce it is export property if the requirements of this section are otherwise satisfied . . ."[14]

C. TAM 8549003 and GCM 39449 (17 February 1983) held that the software described therein qualified as export property.

- A problem with respect to software involves the issue of services. Treas. Reg. § 1.993-3(b) provides:
"*Services.* For purposes of this section, services (including the written communication of services in any form) are not export property. Whether an item is property or services shall be determined on the basis of facts and circumstances attending to the development and disposition of the item. Thus, for example, the *preparation of a map of a particular construction site would constitute services and not export property, but standard maps* prepared for sale to customers generally would not constitute services and *would be export property* if the requirements of this section were otherwise met." (Emphasis added)
- Accordingly, the distinction between customized programs and "shelf" programs could be significant in considering whether a software license qualifies for DISC treatment: "shelf" programs should more easily qualify. See TAM 8549003 and GCM 39449 (17 February 1983).

4. Blocked income.

A. Blocked income rules may apply when the IRS proposes to make a § 482 allocation, but payment was prevented at the time of the transaction because of currency or other restrictions imposed under the laws of a foreign country. The U.S. taxpayer is permitted to treat the allocated income as deferrable income provided it had elected to use the Rev. Rul. 74-351, 1974-2 C.B. 144, deferral method of accounting for the year to which the allocation relates. Treas. Reg. § 1.482-1(d)(6). If the U.S. taxpayer did not make an election to use the deferral method, it may still use a modified § 482 deferral method with respect to the allocated income.

B. The modified § 482 deferral method was the subject of Rev. Rul. 74-245, 1974-1 C.B. 124. The following facts were set forth in the ruling: P, a domestic corporation, entered into a written agreement with S, its foreign subsidiary, permitting S to use certain registered designs and granting S an exclusive license to operate in its country of incorporation. The agreement required S to pay royalties only after the local government approved the agreement, since S would be unable to pay royalties until it received such approval. P was advised by "competent" local counsel that the foreign government would not be receptive to a request by S for approval of the agreement and that the local government might impose economic

13. "Lease" and "license" appear to be interchangeable under the DISC rules. See Treas. Reg. § 1.993-1(a)(2). TAM 8549003 and GCM 39449 (17 February 1983) referred to software transactions as giving rise to "sales" and "rents".

14. The next section and this subsection of the regulations covers master recording tapes and provides that they qualify as export property even though the license permits reproduction. However, this appears to constitute a special exception for record producers derived from legislative history. See S. Rept. No. 92-437, 92 Cong., 1st Sess. 102, reprinted at 1972-1 C.B. 559, 616 (1972).

sanctions on S if P attempted to enforce the agreement to make payments. Consequently, the Service ruled that it would not be necessary to seek local government approval to pay royalties under the agreement and that the royalty income would qualify as deferrable income within the meaning of Treas. Reg. § 1.482-1(d)(6).

C. Rev. Rul. 76-243, 1976-1 C.B. 134, involved a contractual restriction, which the IRS wouldn't respect on the grounds it constituted a "voluntary" restriction even though the taxpayer may not otherwise have been able to get the contract with the foreign government.

D. Rev. Rul. 82-45, 1982-1 C.B. 82, involved technical service agreements between P and S providing for 5% royalties which were reduced by the foreign government to 4% and 2%, respectively. In addition, the term of the agreement was shortened by the foreign government. The Service ruled that *First Security Bank of Utah v. Commissioner,* 405 U.S. 394 (1972), only applies where the taxpayer is prevented from receiving income by U.S. law. The Service has also ruled that an allocation can be made, even though Treas. Reg. § 1.482-1(d)(6) (re blocked income) may be available. TAM 8001017. The problem, of course, has to do with allocating expenses to the blocked income, although this was not mentioned in the tech advice. TAM 8324007 apparently would allow a contingent Treas. Reg. § 1.482-1(d)(6) election, but not a delayed election. GCM 38545 (17 October 1980) was the GCM underlying Rev. Rul. 82-45.

E. TAM 8513007 GCM 39350 (31 August 1984) held that a blocked income election under § 482 prevented a correlative E&P adjustment. The GCM states that this result should follow under § 267 for post-DEFRA years.

5. *Pitchford's* and accrual.

A. In one of the most interesting, and perhaps, significant recent § 482 cases, *Pitchford's, Inc.,* 34 T.C.M. 384 (1975), the taxpayer, an accrual-basis corporation, was not required to take § 482 interest in income because it could not reasonably expect to collect that income. The Service conceded the tax accounting issue as a legal matter and fought the taxpayer on factual grounds, i.e. whether in fact the taxpayer had a reasonable expectancy of receiving the interest income. The Court expressed "no views on the question whether allocation of interest income under § 482 is indeed precluded where there would not have been a reasonable expectancy of collection of such interest." 34 T.C.M., at 386. Although the Service's concession would seem to be in accord with arm's lenth concepts, the Service apparently has since adopted a contrary position. See, *Sunshine Department Stores, Inc.* 42 T.C.M. 1379 (1981) (taxpayer argued no reasonable expectation of repayment, but court did not decide § 482 vs. accrual issue; IRS, in any event, did not concede issue) and *Robert E. Johnson* 44 T.C.M. 1076 (1982) (seemingly holding that accrual principles override § 482).

B. As a threshold matter, the same type of tax accounting argument could be made with regard to a proposed § 482 royalty allocation. However, changes of success in making such an argument might depend upon the terms of the parties' license agreement. In *Koehring Company v. United States,* 421 F.2d 715 (Ct. Cl. 1970), the taxpayer argued unsuccessfully that it should not be required to accrue royalty income from its partially-owned Japanese subsidiary because of the subsidiary's financial problems. The Court held that the taxpayer's right to receive the income became fixed under its license agreement. Also, there was no real doubt about the ultimate receipt of the royalties, as the subsidiary's financial difficulties were regarded by the taxpayer as temporary in nature.

C. A similar result was reached in *Waldo B. Russell,* 3T.C.M.613 (1944), where the taxpayer claimed that, by reason of its subsidiary-licensee's operating loss, no royalties were due or properly accruable. The Court noted that there was a custom or practice to waive payments in the absence of profits. However, the parties written license agreement did not contain a provision authorizing such waivers and there was no evidence the royalties were otherwise uncollectible. Consequently, the Court held "we are unable to find that these royalties were not legally payable by the subsidiary" and that accrual was in order.

D. Difficulty in making a *Pitchford's* argument also can be expected if the licensor has continued to supply its subsidiary with information concerning related technological improvements. Note that the *Pitchford's* case involved "old and cold" debt, not current advances. Additionally, it may be difficult to argue for nonaccrual if the taxpayer's third-party license agreements provide for termination in the event of nonpayment and the subsidiary-licensee's agreement has not been terminated. Acrual might be necessary on the grounds that the taxpayer expects eventually to be paid.

6. Foreign tax credit effects.

A. Rev. Rul. 72-371, 1972-2 C.B. 438, involved the payment of royalties by one foreign subsidiary of a U.S. corporation to another foreign subsidiary. The paying subsidiary withheld a local tax from the remittance. The IRS subsequently reallocated all of the royalty income to the U.S. parent corporation under § 482. The IRS ruled that the U.S. parent corporation could take a § 901 foreign tax credit for a portion of the withheld tax on the grounds that, had the remittance been made to it, the withheld tax (or, at least, a portion of it) could have been claimed as a foreign tax credit. See GCM 34565 (28 July 1971).

B. Foreign tax credits also might be affected by Treas.

Reg. § 1.482-1(d)(2), which permits "correlative adjustments". If an income allocation reduces the foreign subsidiary's earnings and profits, § 902 foreign tax credits may be accelerated. See Rev. Rul. 74-158, 1974-1 C.B. 182; but see Rev. Ruls. 76-508, 1976-2 C.B. 225, and 80-231, 1980-2 C.B. 219. However, if all of the foreign subsidiary's income for a particular year is reallocated, foreign tax credits may be lost. Rev. Rul. 72-370, 1972-2 C.B. 437, and GCM 34565 (28 July 1971).

7. Rev. Proc. 65-17 and repatriation.

A. It may be desirable to repatriate the allocated income on a U.S.-tax free basis under Rev. Proc. 65-17, 1965-1 C.B. 833.[15] To avail itself of relief under Rev. Proc. 65-17, a U.S. taxpayer must be able to demonstrate that "the arrangements or transactions, or the terms thereof, giving rise to the § 482 allocation did not have as one of their principal purposes the avoidance of federal income tax."

B. All facts and circumstances are relevant, including the amount of dividends received from the member from which the income was allocated and the amount of U.S. and foreign income taxes levied on the parties and

"... whether the taxpayer attempted in good faith to comply with the regulations theretofore promulgated under § 482 ... [and] the extent to which the arrangement contravened such regulations ..."

C. Thus, it is important that intercompany transactions comply with the § 482 regulations or that a serious attempt be made to have them comply. Unfortunately, as stated above, the "intangibles" regulations don't offer a great deal of guidance. Nevertheless, it is advisable to document what compliance is possible to help insure that relief under Rev. Proc. 65-17 will be available in the event the Service is successful in revising the intercompany royalty rate at some later date.

8. Set-off.

A. Set-off relief may be available under either Treas. Reg. § 1.482-1(d)(3) or Treas. Reg. § 1.482-2(d)(1)(ii)(b). Both provisions, however, are quite narrow.

B. The first provision involves non-arm's length transactions with the same member in the same year. It also places the burden on the taxpayer to prove the amount of the appropriate arm's length charge and it imposes certain time limits with regard to when relief may be claimed. See Rev. Proc. 70-8, 1970-1 C.B. 434.

C. The second provision relates only to the particular intangible property involved in the allocation, although multi-year relief may be available. Treas. Reg. § 1.482-2(d)(1)(ii)(d) example No. 3.

VIII. TAXATION IN THE LICENSEE'S COUNTRY

1. Introduction.

A. A domestic licensor also must concern itself with the foreign tax consequences to its related licensee. For example, in the past, at least, some domestic licensors billed their foreign, related licensees for a service charge, a royalty, or both, depending upon the characterization that resulted in the most favorable foreign tax treatment.

B. Proper tax planning for intercompany licensing transactions requires country-by-country consideration and frequently will entail consultation with local tax advisers.

2. Deductibility.

A. As a general rule, annual royalties for technology used in the licensee's business are deductible when based on sales. See *Crowe* "General Report, Tax Treatment of the Importation and Exportation of Technology, Know-how, Patents, Other Intangibles and Technical Assistance," 1/8 (International Fiscal Association, 1975). A number of countries were discussed.

B. There are, however, a number of exceptions to this general rule in South America, where related-party royalties often are not deductible. The Andean Pact countries present a particular problem. Brazil also does not permit deductions for related-party royalties. Argentina presented problems in the early 1970s.

C. The tax authorities in other countries have argued on occasion that a deduction may not be claimed for royalties paid by a related party. The French tax authorities argued unsuccessfully in a 1970 case that a foreign parent corporation had contributed a trademark to its French subsidiary's capital and that, therefore, royalty deductions should be disallowed. Conseil d'Etat decision of 19 June 1970. The taxpayer produced sufficient evidence to demonstrate that the trademark had not been contributed to its capital. In Belgium, the tax authorities successfully contended in a 1972 case that royalties paid to a foreign parent corporation by its Belgian subsidiary for the use of the parent's name were non-deductible. Cour d'Appel decision of 4 October 1972. The subsidiary's charter of incorporation did not provide for such compensation and the Court would not recognize the parties' later agreement. Also, the Court held that the name had no special value.

3. Related parties: Germany.

A. German administrative rules are relatively well-developed. New German "§ 482" regulations became final on 23 February 1983.

15. Rev. Proc. 65-17, 1965-1 C.B. 833; Rev. Proc. 65-17 Amendment I, 1966-1 C.B. 1211; Rev. Proc. 70-23, 1970-2 C.B. 505; Rev. Proc. 71-35, 1971-2 C.B. 573; Rev. Proc. 72-48, 1972-2 C.B. 829; Rev. Proc. 75-53, 1972-2 C.B. 833; and Rev. Proc. 65-17 Amendment II, 1974-1 C.B. 411.

B. Royalties generally are allowable where the German subsidiary is merely a sales company for its foreign parent-manufacturer. Such sums usually are deemed to be included in the cost of goods imported, although this deemed inclusion can be rebutted. Know-how payments are more easily deductible when paid by a German manufacturing company.

4. Related parties: France.

A. France also is active in examining related-party transactions under Article 57 of its General Tax Code (Code Général des Impôts, or CGI).

B. The French tax authorities issued a "Note" on 4 May 1973 that focused in part on related-party royalty charges from abroad.[16] It described such royalty charges as usually "remunerating the foreign corporation for services rendered, such as the granting of a patent license, permission to use certain non-patented processes or manufacturing methods, technical or scientific assistance, or help with commercial or administration procedures" and it provided that "the French tax administration's task is to determine whether these payments . . . are excessive".

C. The Note stated that the tax administration will closely examine intercompany sales prices where the foreign licensor also is supplying goods to its French subsidiary to make sure the French company is not paying twice for the same item. It further indicated that it is commonly argued that subsidiaries must contribute to research costs incurred on behalf of the group or that they must repay part of the cost of the investment in know-how made by the foreign parent from which the French subsidiary is benefitting. Such arguments must properly be substantiated before they will be accepted.

D. The French tax administration will, as a rule, only allow a deduction for related-party royalties if the French subsidiary's net income is at least equal to the net income which would be derived by a French enterprise carrying on similar operations, but without the aid of such an arrangement. Special problems will arise where the French subsidiary incurs local publicity expenses because the French tax authorities view the establishment of the group's name as a benefit to the parent corporation. Also, recommendations made by other French services, such as the Ministère du Dévéloppement Industriel et Scientifique, do not bind the tax administration. Lastly, if the French subsidiary's deduction for royalty payments is reduced under Art. 57 CGI, the subsidiary will be deemed to have distributed a dividend to its foreign parent corporation that is subject to French withholding tax.

5. Related parties: Canada.

A. Canada polices related-party licensing under § 69(2) of its Income Tax Act, which requires that the royalty payable to a non-resident licensor with whom the licensee was not dealing at arm's length be "reasonable" in amount.

B. In ascertaining "the reasonable amount," the Department of National Revenue has shown considerable interest in the value of tangible benefits received by the Canadian taxpayer.
For example, the Canadian licensee's position in arguing for a deduction is stronger if it can show that it increased its product line or has improved existing products sold or services rendered as a result of the acquired technology.

C. Revenue Canada considers the total consideration for both technology and goods if the licensor also sells goods to the licensee that are manufactured with the same technology.

D. Evidence of comparable arm's length transactions will help establish "the reasonable amount".

6. Related parties: Italy.

A. Instructions in Circular 9/2267 of 9-22-80 apply to related party transfers of technology, among other things. A draft Presidential Decree has also been issued directed towards tax and exchange control issues.

B. Compensation paid to non-resident companies for the right to use trademarks, patents and similar rights would be subject to corporate income tax at the rate of 30% on 70% of the gross amount paid, subject, of course, to treaty reduction.

C. The royalty payments would not be subject to ILOR (local income tax). The prior ILOR problem is described in LTR 8323094.

7. Local taxes imposed on the licensor.

A. Local taxes that are imposed on the licensor also must be considered in connection with intercompany licensing transactions. Local taxes on royalty income often are reduced by income tax treaties. However, licensees may be located in non-treaty countries and, even in the case of treaty countries, other local tax problems may be lurking.

B. The licensor's deductions.
- It is not unusual for a licensor to be permitted to claim an arbitrary percentage deduction in computing its local tax. For example, New Zealand subjects foreign licensors to a non-resident corporate tax, but it permits them to deduct arbitrary amounts depending upon the category of technology involved: 25% is deductible from trademark royalties, 35% from patent royalties, 50% from know-how royalties, and 40% is deductible in the case of "combination" royalties. Higher deductions may be claimed if they can be supported.
- In a New Zealand case, the New Zealand tax

16. See 13 European Taxation 8 (1973) at 265.

authorities argued that a related-party royalty was for a combination of know-how and trademarks and that, therefore, the licensor was entitled only to a 40% deduction, not the 50% deduction that had been claimed. The parties' license agreement provided for a conveyance of know-how (accompanied by certain technical assistance) in exchange for a royalty equal to 5% of the selling price of certain chemical substances sold under "the trademarks X, Y and Z", which were registered in the licensor's name. The case in favor of the taxpayer because "it is clear from the agreement that it refers in specific detail to 'know-how' and that nowhere in it is there any provision concerning use of a particular trademark or a covenant whereby . . . [the licensee] must use a particular trademark". The Authority also noted the tax authority's acknowledgement that "the value of the trademark on its own is minimal". Although the taxpayer won this case, it emphasizes the need for careful draftsmanship in preparing a license agreement.

C. The nature of the transaction.
- The parties' license agreement also can have a significant effect upon the licensor's local tax liability when services are involved, as the place of performance might have the effect of completely eliminating local tax.
- Additionally, the nature of the consideration flowing to the licensee may be relevant in determining the licensor's local tax liability. For example, Canada exempts from withholding payments made under a bona fide cost-sharing arrangement.
- The structure of the transaction also must be considered. For example, in a 1968 Belgian case, Cour de Cassation decision of 17 December 1968, a partially owned Belgian subsidiary, ostensibly a licensee, was held to be an agent for its foreign parent, ostensibly the licensor, which became subject to full Belgian tax. The foreign parent sold patents, trademarks, goodwill, plans, and blueprints to the subsidiary in exchange for 45% of the subsidiary's profits. A Belgian manufacturing company was entitled to another 45% of the subsidiary's profits. The sales agreement was held to be "fictitious." Since no sale occurred, payments received by the foreign parent were held to constitute income from business operations in Belgium, i.e. the sale of machines and exploitation of patent rights, through a Belgian permanent establishment (the subsidiary, as agent).
- "Permanent establishment" questions, of course, are always important.

D. Local taxes may include non-federal taxes in the local country. Italy has presented problems in this regard in the past. The Draft Italian Presidential Decree mentioned above would eliminate the problem. See also Circular 9/2267 of 9-22-80.

8. Other local considerations.

A. Registration of license agreement is an important requirement in many countries. In Mexico, registration is a prerequisite do deductibility. In addition, failure to satisfy registration requirements can have an adverse effect upon the local withholding tax rate. See, for example, the Third Chamber of the Spanish Supreme Court decision of 28 June 1973. The Spanish licensee had failed to register a know-how agreement. The Court held that reduced withholding under the relevant treaty therefore was not available.

B. Remittability and other local taxes, such as the European value added tax, also are important considerations.

Appendix

SEC. 161. ALLOWANCE OF DEDUCTIONS

In computing taxable income under section 63, there shall be allowed as deductions the items specified in this part, subject to the exceptions provided in part IX (Sec. 261 and following, relating to items not deductible).

SEC. 351. TRANSFER TO CORPORATION CONTROLLED BY TRANSFEROR

(a) General Rule.– No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation and immediately after the exchange such person or persons are in control (as defined in section 368(c)) of the corporation.

(b) Receipt of Property.– If subsection (a) would apply to an exchange but for the fact that there is received, in addition to the stock or securities permitted to be received under subsection (a), other property or money, then–
(1) gain (if any) to such recipient shall be recognized, but not in excess of–
  (A) the amount of money received, plus
  (B) the fair market value of such other property received; and
(2) no loss to such recipient shall be recognized.

(c) Special Rule.– In determining control, for purposes of this section, the fact that any corporate transferor distributes part or all of the stock which it receives in the exchange to its shareholders shall not be taken into account.

(d) Services, Certain Indebtedness, and Accrued Interest Not Treated as Property.– For purposes of this section, stock or securities issued for–
(1) services,
(2) indebtedness of the transferee corporation which is not evidenced by a security, or
(3) interest on indebtedness of the transferee corporation which accrued on or after the beginning of the transferor's holding period for the debt,
shall not be considered as issued in return for property.

(e) Exceptions.– This section shall not apply to–
(1) Transfer of property to an investment company.– A transfer of property to an investment company.
(2) Title 11 or similar case.– A transfer of property of a debtor pursuant to a plan while the debtor is under the jurisdiction

of a court in a title 11 or similar case (within the meaning of section 368(a)(3)(A)), to the extent that the stock or securities received in the exchange are used to satisfy the indebtedness of such debtor.

SEC. 361. NONRECOGNITION OF GAIN OR LOSS TO CORPORATIONS

(a) General Rule.– No gain or loss shall be recognized if a corporation a party to a reorganization exchanges property, in pursuance of the plan of reorganization, solely for stock or securities in another corporation a party to the reorganization.

(b) Exchanges Not Solely in Kind.–
(1) Gain.– If subsection (a) would apply to an exchange but for the fact that the property received in exchange consists not only of stock or securities permitted by subsection (a) to be received without the recognition of gain, but also of other property or money, then–
(A) if the corporation receiving such other property or money distributes it in pursuance of the plan of reorganization, no gain to the corporation shall be recognized from the exchange, but
(B) if the corporation receiving such other property or money does not distribute it in pursuance of the plan of reorganization, the gain, if any, to the corporation shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property so received, which is not so distributed.
(2) Loss.– If subsection (a) would apply to an exchange but for the fact that the property received in exchange consists not only of property permitted by subsection (a) to be received without the recognition of gain or loss, but also of other property or money, then no loss from the exchange shall be recognized.

SEC. 362. BASIS TO CORPORATIONS

(a) Property Acquired by Issuance of Stock or as Paid-in Surplus.– If property was acquired on or after June 22, 1954, by a corporation–
(1) in connection with a transaction to which section 351 (relating to transfer of property to corporation controlled by transferor) applies, or
(2) as paid-in surplus or as a contribution to capital,
then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain recognized to the transferor on such transfer.

(b) Transfers to Corporations.– If property was acquired by a corporation in connection with a reorganization to which this part applies, then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain recognized to the transferor on such transfer. This subsection shall not apply if the property acquired consists of stock or securities in a corporation a party to the reorganization, unless acquired by the exchange of stock or securities of the transferee (or of a corporation which is in control of the transferee) as the consideration in whole or in part for the transfer.

SEC. 367. FOREIGN CORPORATIONS

(a) Transfers of Property From the United States.–

(1) General Rule.– If, in connection with any exchange described in section 332, 351, 354, 355, 356, or 361, a United States person transfers property to a foreign corporation, such foreign corporation shall not, for purposes of determining the extent to which gain shall be recognized on such transfer, be considered to be a corporation.
(2) Exception for certain stock or securities.– Except to the extent provided in regulations, paragraph (1) shall not apply to the transfer of stock or securities of a foreign corporation which is a party to the exchange or a party to the reorganization.
(3) Exception for transfers of certain property used in the active conduct of a trade or business.–
(A) In general.– Except as provided in regulations prescribed by the Secretary, paragraph (1) shall not apply to any property transferred to a foreign corporation for use by such foreign corporation in the active conduct of a trade or business outside of the United States.
(B) Paragraph not to apply to certain property.– Except as provided in regulations prescribed by the Secretary, subparagraph (A) shall not apply to any–
(i) property described in paragraph (1) or (3) of section 1221 (relating to inventory and copyrights, etc.),
(ii) installment obligations, accounts receivable, or similar property,
(iii) foreign currency or other property denominated in foreign currency,
(iv) intangible property (within the meaning of section 936(h)(3)(B)), or
(v) property with respect to which the transferor is a lessor at the time of the transfer, except that this clause shall not apply if the transferee was the lessee.
(C) Transfer of foreign branch with previously deducted losses.– Except as provided in regulations prescribed by the Secretary, subparagraph (A) shall not apply to gain realized on the transfer of the assets of a foreign branch of a United States person to a foreign corporation in an exchange described in paragraph (1) to the extent that–
(i) the sum of losses–
(I) which were incurred by the foreign branch before the transfer, and
(II) with respect to which a deduction was allowed to the taxpayer, exceeds
(ii) the sum of–
(I) any taxable income of such branch for a taxable year after the taxable year in which the loss was incurred and through the close of the taxable year of the transfer, and
(II) the amount which is recognized under section 904(f)(3) on account of the transfer.
Any gain recognized by reason of the preceding sentence shall be treated for purposes of this chapter as income from sources outside the United States having the same character as such losses had.
(4) Special rule for transfer of partnership interests.– Except as provided in regulations prescribed by the Secretary, a transfer by a United States person of an interest in a partnership to a foreign corporation in an exchange described in paragraph (1) shall, for purposes of this subsection, be treated as a transfer to such corporation of such person's pro rata share of the assets of the partnership.
(5) Secretary may exempt certain transactions from application of this subsection.– Paragraph (1) shall not apply to the transfer of any property which the Secretary, in order to carry out the purposes of this subsection, designates by regulation.

(b) Other Transfers.–

(1) Effect of section to be determined under regulations.– In the case of any exchange described in section 332, 351, 354, 355, 356, or 361 in connection with which there is no transfer of property described in subsection (a)(1), a foreign corporation shall be considered to be a corporation except to the extent provided in regulations prescribed by the Secretary which are necessary or appropriate to prevent the avoidance of Federal income taxes.
(2) Regulations relating to sale or exchange of stock in foreign corporations.– The regulations prescribed pursuant to paragraph (1) shall include (but shall not be limited to) regulations dealing with the sale or exchange of stock or securities in a foreign corporation by a United States person, including regulations providing–
(A) the circumstances under which–
(i) gain shall be recognized currently, or amounts included in gross income currently as a dividend, or both, or
(ii) gain or other amounts may be deferred for inclusion in the gross income of a shareholder (or his successor in interest) at a later date, and
(B) the extent to which adjustments shall be made to earnings and profits, basis of stock or securities, and basis of assets.

(c) Transactions To Be Treated as Exchanges.–

(1) Section 355 distribution.– For purposes of this section any distribution described in section 355 (or so much of section 356 as related to section 355) shall be treated as an exchange whether or not it is an exchange.

(2) Contribution of capital to controlled corporations.– For purposes of this chapter, any transfer of property to a foreign corporation as a contribution to the capital of such corporation by one or more persons who, immediately after the transfer, own (within the meaning of section 318) stock possessing at least 80% of the total combined voting power of all classes of stock of such corporation entitled to vote shall be treated as an exchange of such property for stock of the foreign corporation equal in value to the fair market value of the property transferred.

(d) Special Rules Relating to Transfers of Intangibles.–

(1) In general.– Except as provided in regulations prescribed by the Secretary, if a United States person transfers any intangible property (within the meaning of section 936(h)(3)(B)) to a foreign corporation in an exchange described in section 351 or 361–
   (A) subsection (a) shall not apply to the transfer of such property, and
   (B) the provisions of this subsection shall apply to such transfer.

(2) Transfer of intangibles treated as transfer pursuant to sale of contingent payments.–
   (A) In general.– If paragraph (1) applies to any transfer, the United States person transferring such property shall be treated as–
      (i) having sold such property in exchange for payments which are contingent upon the productivity, use, or disposition of such property, and
      (ii) receiving amounts which reasonably reflect the amounts which would have been received–
         (I) annually in the form of such payments over the useful life of such property, or
         (II) in the case of disposition following such transfer (whether direct or indirect), at the time of the disposition.
   (B) Effect on earnings and profits.– For purposes of this chapter, the earnings and profits of a foreign corporation to which the intangible property was transferred shall be reduced by the amount required to be included in the income of the transferor of the intangible property under subparagraph (A)(ii).
   (C) Amounts received treated as United States source ordinary income.– For purposes of this chapter, any amount included in gross income by reason of this subsection shall be treated as ordinary income from sources within the United States.

SEC. 482. ALLOCATION OF INCOME AND DEDUCTIONS AMONG TAXPAYERS

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

SEC. 483. INTEREST ON CERTAIN DEFERRED PAYMENTS

(a) Amounts Constituting Interest.– For purposes of this title, in the case of any payment–
(1) under any contract for the sale or exchange of any property, and
(2) to which this section applies,
there shall be treated as interest that portion of the total unstated interest under such contract which, as determined in a manner consistent with the method of computing interest under section 1272(a), is properly allocable to such payment.

(b) Total Unstated Interest.– For purposes of this section, the term "total unstated interest" means, with respect to a contract for the sale or exchange of property, an amount equal to the excess of–
(1) the sum of the payments to which this section applies which are due under the contract, over
(2) the sum of the present values of such payments and the present values of any interest payments due under the contract.
For purposes of the preceding sentence, the present value of a payment shall be determined under the rules of section 1274(b)(2) using a discount rate equal to the applicable Federal rate determined under section 1274(d).

(c) Payments to Which Subsection (a) Applies.–

(1) In general.– Except as provided in subsection (d), this section shall apply to any payment on account of the sale or exchange of property which constitutes part or all of the sales price and which is due more than 6 months after the date of such sale or exchange under a contract–
   (A) under which some or all of the payments are due more than 1 year after the date of such sale or exchange, and
   (B) under which there is total unstated interest.

(2) Treatment of other debt instruments.– For purposes of this section, a debt instrument of the purchaser which is given in consideration for the sale or exchange of property shall not be treated as a payment, and any payment due under such debt instrument shall be treated as due under the contract for the sale or exchange.

(3) Debt instrument defined.– For purposes of this subsection, the term "debt instrument" has the meaning given such term by section 1275(a)(1).

(d) Exceptions and Limitations.–

(1) Coordination with original issue discount rules.– This section shall not apply to any debt instrument to which section 1272 applies.

(2) Sales prices of $3,000 or less.– This section shall not apply to any payment on account of the sale or exchange of property if it can be determined at the time of such sale or exchange that the sales price cannot exceed $3,000.

(3) Carrying charges.– In the case of the purchaser, the tax treatment of amounts paid on account of the sale or exchange of property shall be made without regard to this section if any such amounts are treated under section 163(b) as if they included interest.

(4) Certain sales of patents.– In the case of any transfer described in section 1235(a) (relating to sale or exchange of patents), this section shall not apply to any amount contingent on the productivity, use, or disposition of the property transferred.

(e) Maximum Rate of Interest on Certain Transfers of Land Between Related Parties.–

(1) In general.– In the case of any qualified sale, the discount rate used in determining the total unstated interest rate under subsection (b) shall not exceed 6%, compounded semiannually.

(2) Qualified sale.– For purposes of this subsection, the term "qualified sale" means any sale or exchange of land by an individual to a member of such individual's family (within the meaning of section 267(c)(4)).

(3) $500,000 limitation.– Paragraph (1) shall not apply to any qualified sale between individuals made during any calendar year to the extent that the sales price for such sale (when added to the aggregate sales price for prior qualified sales between such individuals during the calendar year) exceeds $500,000.

(4) Nonresident alien individuals.– Paragraph (1) shall not apply to any sale or exchange if any party to such sale or exchange is a nonresident alien individual.

(f) Regulations.– The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this section including regulations providing for the application of this section in the case of–
(1) any contract for the sale or exchange of property under which the liability for, or the amount or due date of, a payment

cannot be determined at the time of the sale or exchange, or
(2) any change in the liability for, or the amount or due date of, any payment (including interest) under a contract for the sale or exchange of property.

SEC. 901. TAXES OF FOREIGN COUNTRIES AND OF POSSESSIONS OF THE UNITED STATES

(a) Allowance of Credit.– If the taxpayer chooses to have the benefits of this subpart, the tax imposed by this chapter shall, subject to the limitation of section 904, be credited with the amounts provided in the applicable paragraph of subsection (b) plus, in the case of a corporation, the taxes deemed to have been paid under sections 902 and 960. Such choice for any taxable year may be made or changed at any time before the expiration of the period prescribed for making a claim for credit or refund of the tax imposed by this chapter for such taxable year. The credit shall not be allowed against any tax treated as a tax not imposed by this chapter under section 26(b).

(b) Amount Allowed.– Subject to the limitation of section 904, the following amounts shall be allowed as the credit under subsection (a):
(1) Citizens and domestic corporations.– In the case of a citizen of the United States and of a domestic corporation, the amount of any income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country or to any possession of the United States; and
(2) Resident of the United States or Puerto Rico.– In the case of a resident of the United States and in the case of an individual who is a bona fide resident of Puerto Rico during the entire taxable year, the amount of any such taxes paid or accrued during the taxable year to any possession of the United States; and
(3) Alien resident of the United States or Puerto Rico.– In the case of an alien resident of the United States and in the case of an alien individual who is a bona fide resident of Puerto Rico during the entire taxable year, the amount of any such taxes paid or accrued during the taxable year to any foreign country; and
(4) Nonresident alien individuals and foreign corporations.– In the case of any nonresident alien individual not described in section 876 and in the case of any foreign corporation, the amount determined pursuant to section 906; and
(5) Partnerships and estates.– In the case of any individual described in paragraph (1), (2), (3), or (4), who is a member of a partnership or a beneficiary of an estate or trust, the amount of his proportionate share of the taxes (described in such paragraph) of the partnership or the estate or trust paid or accrued during the taxable year to a foreign country or to any possession of the United States, as the case may be.

(c) Similar Credit Required for Certain Alien Residents.– Whenever the President finds that–
(1) a foreign country, in imposing income, war profits, and excess profits taxes, does not allow to citizens of the United States residing in such foreign country a credit for any such taxes paid or accrued to the United States or any foreign country, as the case may be, similar to the credit allowed under subsection (b)(3),
(2) such foreign country, when requested by the United States to do so, has not acted to provide such a similar credit to citizens of the United States residing in such foreign country, and
(3) it is in the public interest to allow the credit under subsection (b)(3) to citizens or subjects of such foreign country only if it allows such a similar credit to citizens of the United States residing in such foreign country,

the President shall proclaim that, for taxable years beginning while the proclamation remains in effect, the credit under subsection (b)(3) shall be allowed to citizens or subjects of such foreign country only if such foreign country, in imposing income, war profits, and excess profits taxes, allows to citizens of the United States residing in such foreign country such a similar credit.

(d) Treatment of Dividends From a DISC or Former DISC.– For purposes of this subpart, dividends from a DISC or former DISC (as defined in section 992(a)) shall be treated as dividends from a foreign corporation to the extent such dividends are treated under part I as income from sources without the United States.

(e) Foreign Taxes on Mineral Income.–
(1) Reduction in amount allowed.– Notwithstanding subsection (b), the amount of any income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country or possession of the United States with respect to foreign mineral income from sources within such country or possession which would (but for this paragraph) be allowed under such subsection shall be reduced by the amount (if any) by which–
  (A) the amount of such taxes (or, if smaller, the amount of the tax which would be computed under this chapter with respect to such income determined without the deduction allowed under section 613), exceeds
  (B) the amount of the tax computed under this chapter with respect to such income.
(2) Foreign mineral income defined.– For purposes of paragraph (1), the term "foreign mineral income" means income derived from the extraction of minerals from mines, wells, or other natural deposits, the processing of such minerals into their primary products, and the transportation, distribution, or sale of such minerals or primary products. Such term includes, but is not limited to–
  (A) dividends received from a foreign corporation in respect of which taxes are deemed paid by the taxpayer under section 902, to the extent such dividends are attributable to foreign mineral income, and
  (B) that portion of the taxpayer's distributive share of the income of partnerships attributable to foreign mineral income.

(f) Certain Payments for Oil or Gas Not Considered as Taxes.– Notwithstanding subsection (b) and sections 902 and 960, the amount of any income*, or profits, and excess profits taxes paid or accrued during the taxable year to any foreign country in connection with the purchase and sale of oil or gas extracted in such country is not to be considered as tax for purposes of section 275(a) and this section if–
(1) the taxpayer has no economic interest in the oil or gas to which section 611(a) applies, and
(2) either such purchase or sale is at a price which differs from the fair market value for such oil or gas at the time of such purchase or sale.

(g) Certain Taxes Paid With Respect to Distributions From Possessions Corporations.–
(1) In general.– For purposes of this chapter, any tax of a foreign country or possession of the United States which is paid or accrued with respect to any distribution from a corporation–
  (A) to the extent that such distribution is attributable to periods during which such corporation is a possessions corporation, and
  (B) (i) if a dividends received deduction is allowable with respect to such distribution under part VIII of subchapter B, or
    (ii) to the extent that such distribution is received in connection with a liquidation or other transaction with respect to which gain or loss is not recognized,

  shall not be treated as income, war profits, or excess profits taxes paid or accrued to a foreign country or possession of the United States, and no deduction shall be allowed under this title with respect to any amount so paid or accrued.
(2) Possessions corporation.– For purposes of paragraph (1), a corporation shall be treated as a possessions corporation for any period during which an election under section 936 applied to such corporation, during which section 931 (as in effect on the day before the date of the enactment of the tax Reform Act of 1976) applied to such corporation, or during which section 957(c) applied to such corporation.

(h) Taxes Paid With Respect to Foreign Trade Income.– No credit shall be allowed under this section for any income, war profits, and

*So in original. Should probably read "war".

excess profits taxes paid or accrued with respect to the foreign trade income (within the meaning of section 923(b)) of a FSC, other than section 923(a)(2) non-exempt income (within the meaning of section 927(d)(6)).

(i) Cross Reference.–

(1) For deductions of income, war profits, and excess profits taxes paid to a foreign country or a possession of the United States, see sections 164 and 275.
(2) For right of each partner to make election under this section, see section 703(b).
(3) For right of estate or trust to the credit for taxes imposed by foreign countries and possessions of the United States under this section, see section 642(a)(1).
(4) For reduction of credit for failure of a United States person to furnish certain information with respect to a foreign corporation controlled by him, see section 6038.

SEC. 902. CREDIT FOR CORPORATE STOCKHOLDER IN FOREIGN CORPORATION

(a) Treatment of Taxes Paid by Foreign Corporation.– For purposes of this subpart, a domestic corporation which owns at least 10% of the voting stock of a foreign corporation from which it receives dividends in any taxable year shall be deemed to have paid the same proportion of any income, war profits, or excess profits taxes paid or deemed to be paid by such foreign corporation to any foreign country or to any possession of the United States, on or with respect to the accumulated profits of such foreign corporation from which such dividends were paid, which the amount of such dividends (determined without regard to section 78) bears to the amount of such accumulated profits in excess of such income, war profits, and excess profits taxes (other than those deemed paid).

(b) Foreign Subsidiary of First and Second Foreign Corporation.–

(1) One tier.– If the foreign corporation described in subsection (a) (hereinafter in this subsection referred to as the "first foreign corporation") owns 10% or more of the voting stock of a second foreign corporation from which it receives dividends in any taxable year, it shall be deemed to have paid the same proportion of any income, war profits, or excess profits taxes paid or deemed to be paid by such second foreign corporation to any foreign country or to any possession of the United States, on or with respect to the accumulated profits of such second foreign corporation from which such dividends were paid, which the amount of such dividends bears to the amount of such accumulated profits in excess of such income, war profits, and excess profits taxes (other than those deemed paid).
(2) Two tiers.– If such first foreign corporation owns 10% or more of the voting stock of a second foreign corporation which, in turn, owns 10% or more of the voting stock of a third foreign corporation from which the second foreign corporation receives dividends in any taxable year, the second foreign corporation shall be deemed to have paid the same proportion of any income, war profits, or excess profits taxes paid by such third foreign corporation to any foreign country or to any possession of the United States, on or with respect to the accumulated profits of such third foreign corporation from which such dividends were paid, which the amount of such dividends bears to the amount of such accumulated profits in excess of such income, war profits, and excess profits taxes.
(3) Voting stock requirement.– For purposes of this subpart–
    (A) paragraph (1) shall not apply unless the percentage of voting stock owned by the domestic corporation in the first foreign corporation and the percentage of voting stock owned by the first foreign corporation in the second foreign corporation when multiplied together equal at least 5%, and
    (B) paragraph (2) shall not apply unless the percentage arrived at for purposes of applying paragraph (1) when multiplied by the percentage of voting stock owned by the second foreign corporation in the third foreign corporation is equal to at least 5%.

(c) Applicable Rules.–

(1) Accumulated profits defined.– For purposes of this section, the term "accumulated profits" means, with respect to any foreign corporation, the amount of its gains, profits, or income computed without reduction by the amount of the income, war profits, and excess profits taxes imposed on or with respect to such profits or income by any foreign country or by any possession of the United States. The Secretary shall have full power to determine from the accumulated profits of what year or years such dividends were paid, treating dividends paid in the first 60 days of any year as having been paid from the accumulated profits of the preceding year or years (unless to his satisfaction shown otherwise), and in other respects treating dividends as having been paid from the most recently accumulated gains, profits, or earnings.
(2) Accounting periods.– In the case of a foreign corporation the income, war profits, and excess profits taxes of which are determined on the basis of an accounting period of less than 1 year, the word "year" is used in this subsection, shall be construed to mean such accounting period.

SEC. 954. FOREIGN BASE COMPANY INCOME

(e) Foreign Base Company Services Income.– For purposes of subsection (a)(3), the term "foreign base company services income" means income (whether in the form of compensation, commissions, fees, or otherwise) derived in connection with the performance of technical, managerial, engineering, architectural, scientific, skilled, industrial, commercial, or like services which
(1) are performed for or on behalf of any related person (within the meaning of subsection (d)(3)), and
(2) are performed outside the country under the laws of which the controlled foreign corporation is created or organized.

The preceding sentence shall not apply to income derived in connection with the performance of services which are directly related to the sale or exchange by the controlled foreign corporation of property manufactured, produced, grown, or extracted by it and which are performed prior to the time of the sale or exchange, or of services directly related to an offer or effort to sell or exchange such property. For purposes of paragraph (2), any services performed with respect to any policy of insurance or reinsurance with respect to which the primary insured is a related person (within the meaning of section 864(d)(4)) shall be treated as having been performed in the country within which the insured hazards, risks, losses, or liabilities occur, and except as provided in regulations prescribed by the Secretary, rules similar to the rules of section 953(b) shall be applied in determining the income from such services.

SEC. 1031. EXCHANGE OF PROPERTY HELD FOR PRODUCTIVE USE OR INVESTMENT

(a) Nonrecognition of Gain or Loss From Exchanges Solely in Kind.–

(1) In general.– No gain or loss shall be recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like kind which is to be held either for productive use in a trade or business or for investment.
(2) Exception.– This subsection shall not apply to any exchange of–
    (A) stock in trade or other property held primarily for sale,
    (B) stocks, bonds, or notes,
    (C) other securities or evidences of indebtedness or interest,
    (D) interests in a partnership,
    (E) certificates of trust or beneficial interest, or
    (F) choses in action.
(3) Requirement that property be identified and that exchange be completed not more than 180 days after transfer of exchanged property.– For purposes of this subsection, any property received by the taxpayer shall be treated as property which is not like-kind property if–
    (A) such property is not identified as property to be received in the exchange before the day which is 45 days after the date on which the taxpayer transfers the property relinquished in the exchange, or
    (B) such property is received after the earlier of–
        (i) the day which is 180 days after the date on which the taxpayer transfers the property relinquished in the exchange, or

(ii) the due date (determined with regard to extension) for the transferor's return of the tax imposed by this chapter for the taxable year in which the transfer of the relinquished property occurs.

SEC. 1221. CAPITAL ASSET DEFINED

For purposes of this subtitle, the term "capital asset" means property held by the taxpayer (whether or not connected with his trade or business), but does not include–
(1) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business;
(2) property, used in his trade or business, of a character which is subject to the allowance for depreciation provided in section 167, or real property used in his trade or business;
(3) a copyright, a literary, musical, or artistic composition, a letter or memorandum, or similar property, held by–
(A) a taxpayer whose personal efforts created such property,
(B) in the case of a letter, memorandum, or similar property, a taxpayer for whom such property was prepared or produced, or
(C) a taxpayer in whose hands the basis of such property is determined, for purposes of determining gain from a sale or exchange, in whole or part by reference to the basis of such property in the hands of a taxpayer described in subparagraph (A) or (B);
(4) accounts or notes receivable acquired in the ordinary course of trade or business for services rendered or from the sale of property described in paragraph (1).

SEC. 1249. GAIN FROM CERTAIN SALES OR EXCHANGES OF PATENTS ETC., TO FOREIGN CORPORATIONS

(a) General Rule.– Gain from the sale or exchange after December 31, 1962, of a patent, an invention, model, or design (whether or not patented), a copyright, a secret formula or process, or any other similar property right to any foreign corporation by any United States person (as defined in section 7701(a)(30)) which controls such foreign corporation shall, if such gain would (but for the provisions of this subsection) be gain from the sale or exchange of a capital asset or of property described in section 1231, be considered as ordinary income.

(b) Control.– For purposes of subsection (a), control means, with respect to any foreign corporation, the ownership, directly or indirectly, of stock possessing more than 50% of the total combined voting power of all classes of stock entitled to vote. For purposes of this subsection, the rules for determining ownership of stock prescribed by section 958 shall apply.

SEC. 1253. TRANSFERS OF FRANCHISES, TRADEMARKS, AND TRADE NAMES

(a) General Rule.– A transfer of a franchise, trademark, or trade name shall not be treated as a sale or exchange of a capital asset if the transferor retains any significant power, right, or continuing interest with respect to the subject matter of the franchise, trademark, or trade name.

(b) Definitions.– For purposes of this section–
(1) Franchise.– The term "franchise" includes an agreement which gives one of the parties to the agreement the right to distribute, sell, or provide goods, services, or facilities, within a specified area.
(2) Significant power, right, or continuing interest.– The term "significant power, right, or continuing interest" includes, but is not limited to, the following rights with respect to the interest transferred:
(A) A right to disapprove any assignment of such interest, or any part thereof.
(B) A right to terminate at will.
(C) A right to prescribe the standards of quality of products used or sold, or of services furnished, and of the equipment and facilities used to promote such products or services.
(D) A right to require that the transferee sell or advertise only products or services of the transferor.
(E) A right to require that the transferee purchase substantially all of his supplies and equipment from the transferor.
(F) A right to payments contingent on the productivity, use, or disposition of the subject matter of the interest transferred, if such payments constitute a substantial element under the transfer agreement.
(3) Transfer.– The term "transfer" includes the renewal of a franchise, trademark, or trade name.

(c) Treatment of Contingent Payments by Transferor.– Amounts received or accrued on account of a transfer, sale, or other disposition of a franchise, trademark, or trade name which are contingent on the productivity, use, or disposition of the franchise, trademark, or trade name transferred shall be treated as amounts received or accrued from the sale or other disposition of property which is not a capital asset.

(d) Treatment of Payments by Transferee.–
(1) Contingent payments.– Amounts paid or incurred during the taxable year on account of a transfer, sale, or other disposition of a franchise, trademark, or trade name which are contingent on the productivity, use, or disposition of the franchise, trademark, or trade name transferred shall be allowed as a deduction under section 162(a) (relating to trade or business expenses).
(2) Other payments.– If a transfer of a franchise, trademark, or trade name is not (by reason of the application of subsection (a)) treated as a sale or exchange of a capital asset, any payment not described in paragraph (1) which is made in discharge of a principal sum agreed upon in the transfer agreement shall be allowed as a deduction–
(A) in the case of a single payment made in discharge of such principal sum, ratably over the taxable years in the period beginning with the taxable year in which the payment is made and ending with the ninth succeeding taxable year or ending with the last taxable year beginning in the period of the transfer agreement, whichever period is shorter;
(B) in the case of payment which is one of a series of approximately equal payments made in discharge of such principal sum, which are payable over–
(i) the period of the transfer agreement, or
(ii) a period of more than 10 taxable years, whether ending before or after the end of the period of the transfer agreement,
in the taxable year in which the payment is made; and
(C) in the case of any other payment, in the taxable year or years specified in regulations prescribed by the Secretary, consistently with the preceding provisions of this paragraph.

(e) Exception.– This section shall not apply to the transfer of a franchise to engage in professional football, basketball, baseball, or other professional sport.

SEC. 1491. IMPOSITION OF TAX

There is hereby imposed on the transfer of property by a citizen or resident of the United States, or by a domestic corporation or partnership, or by an estate or trust which is not a foreign estate or trust, to a foreign corporation as paid-in surplus or as a contribution to capital, or to a foreign estate or trust, or to a foreign partnership, an excise tax equal to 35% of the excess of–
(1) the fair market value of the property so transferred, over
(2) the sum of–
(A) the adjusted basis (for determining gain) of such property in the hands of the transferor, plus
(B) the amount of the gain recognized to the transferor at the time of the transfer.

SEC. 1492. NONTAXABLE TRANSFERS

The tax imposed by section 1491 shall not apply–

(1) If the transferee is an organization exempt from income tax under part I of subchapter F of chapter 1 (other than an organization described in section 401(a)); or

(2) To a transfer–
  (A) described in section 367, or
  (B) not described in section 367 but with respect to which the taxpayer elects (before the transfer) the application of principles similar to the principles of section 367, or

(3) To a transfer for which an election has been made under section 1057.

SEC. 1494. PAYMENT AND COLLECTION

(a) Time for payment.– The tax imposed by section 1491 shall, without assessment or notice and demand, be due and payable by the transferor at the time of the transfer, and shall be assessed, collected, and paid under regulations prescribed by the Secretary.

(b) Abatement or refund.– Under regulations prescribed by the Secretary, the tax may be abated, remitted, or refunded if the taxpayer, after the transfer, elects the application of principles similar to the principles of section 367.

U.S.A.:

Recent Developments Relating to the Taxation of International Technology Transfers in the Pharmaceutical Industry*

By Patrick J. Moran

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Congress has been very active in recent years concerning the taxation of technology transfers by U.S. corporations to related foreign or possessions corporations. Major legislative changes were enacted with the Tax Equity and Fiscal Responsibility Act of 1982.[1] Additional major changes were contained in the Deficit Reduction Act of 1984.[2] Still further major changes are proposed in the Tax Reform Act of 1985.[3] This discussion will focus on how these developments affect major international tax planning for technology transfers in the pharmaceutical industry. The changes with respect to Puerto Rico will be examined first, and then the changes with respect to foreign country corporations will be discussed.

PUERTO RICO

Prior to TEFRA, under section 351,[4] a U.S. pharmaceutical company could transfer patents, know-how, and other manufacturing intangible property to a section 936 corporation[5] on a tax-free basis. Because the transferee corporation was a domestic corporation, there was no requirement that the taxpayer obtain any advance or post-transaction ruling from the Internal Revenue Service (hereinafter, the "Service"). After the section 351 exchange the transferee would own the intangible property and, for pricing purposes, would be entitled to earn an economic return on the property. A key feature of this analysis was Revenue Procedure 63-10.[6]

The purpose of Revenue Procedure 63-10 was to provide guidelines in cases involving the application of section 482 to allocate income and expenses between U.S. companies and their manufacturing affiliates in Puerto Rico which qualified under the predecessor of section 936. Inadvertently, the Service had provided industry with a "game plan" for maximizing the potential tax benefit.

Essentially, where no comparable uncontrolled prices can be found, section 3.02, paragraph 3 of the Revenue Procedure 63-10 provides that the Puerto Rico manufacturer should have its prices adjusted so that it will capture the costs which would be incurred in the U.S., if the manufacturing had taken place in the U.S., plus a rate of profit which is representative for that type of U.S. manufacturing activities. However, the foregoing applies only where intangible property is not present as an income-producing factor or, if present, such intangible property belongs to the U.S. company, not the possession company. Section 4 of Revenue Procedure 63-10 provides that, where intangibles are present as an income producing factor, the Puerto Rico manufacturing company is entitled to the strict cost-plus profit pricing if all the intangibles are owned by the U.S. company. On the other hand, where all of the applicable intangibles are owned by the Puerto Rico company it is entitled to all of the income attributable to the intangibles in addition to the cost-plus profit level of prices. Where some, but not all, of the intangibles are owned in Puerto Rico, the income attributable to intangibles is split based on ownership. The revenue procedure contemplates that manufacturing intangibles could be owned in Puerto Rico. However, it does state that in instances where the U.S. company acts as the marketing organization for products produced in

* This article is to be published in the London-based Tax Planning International of the Bureau of National Affairs.
1. Public Law 97-248. Hereinafter "TEFRA".
2. Public Law 98-369. The Tax Reform Act of 1984 is Division A of the Deficit Reduction Act of 1984, and is the portion of the legislation which is of relevance to this discussion. Accordingly, the revenue provisions of Public 98-369 will hereinafter be referred to as "TRA 1984".
3. H.R. 3838. Hereinafter "TRA 1985". As of the date hereof, TRA 1985 has been enacted by the U.S. House of Representatives. It has not yet been reported out of the Senate Finance Committee.
4. Except as otherwise stated, all references to "sections" are to sections of the Internal Revenue Code of 1954, and all references to "regulations" are to Treasury Regulations issued under the Internal Revenue Code of 1954.
5. For the purposes of this discussion, a "section 936 corporation" is a domestic corporation which has elected to receive a credit, under section 936, against its U.S. income tax liability on its possession source income. In order to qualify for the credit, the company must satisfy the conditions set forth in section 936(d)(2). A slightly dated, but still useful, discussion of the mechanics of section 936 may be found in Griggs, Operating in Puerto Rico in the Section 936 Era, 32 *Tax L. Rev.* 239 (1977). Also, for purposes of this discussion, a "section 936 corporation" can also mean a domestic corporation which qualified under the predecessor of section 936, namely, section 931 as in effect for taxable years beginning before 1 January 1976.
6. 1963-1 C.B. 490.

Puerto Rico, such marketing intangibles as market position, consumer acceptance or similar factors of good will attributable to the marketing effort must, as a factual matter, belong to the U.S. marketing company. No special mention is made of trademarks.

Thus, following the logic of Revenue Procedure 63-10, if the U.S. corporation succeeded in putting the ownership of all the applicable manufacturing intangibles into Puerto Rico, the Puerto Rico company would be entitled to the economic return applicable thereto. That is, according to Revenue Procedure 63-10, the economic return applicable to intangible property should inure to the benefit of the *owner* of such property and not necessarily to the benefit of the property's developer. This state of affairs is given by the staff of the Joint Committee on Taxation in the General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982 (hereinafter, "TEFRA General Explanation") as one of the Reasons for Change:

> For instance, a U.S. pharmaceutical company could spend (and deduct or amortize and take a research and development tax credit for) large sums on research and development of new drugs. When it developed an effective drug, it could transfer the patent on the drug and the know-how to manufacture the drug to a section 936 subsidiary in a purportedly tax-free exchange. Thereafter, the 936 company could manufacture the drug and claim for itself the extremely high profits which typically result from the sale of pharmaceutical products. It was Congress' understanding that high profits on certain pharmaceutical products must be realized because, according to the industry, the profits from the relatively few successful drugs must, in effect, amortize the development costs of all unsuccessful products and finance the necessary research and development for future products. This results in the creation of extremely valuable intangibles (e.g. patents and trademarks) in the drug industry. If there is no allocation of income from the intangibles to their developer (the U.S. parent), a distortion of income results, with the parent obtaining deductions for its efforts which the 936 company realizes as tax-free income.
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> TEFRA General Explanation 82, 83

It should be noted that the basic logic of Revenue Procedure 63-10, and its position that the 936 company, as owner of the valuable intangible property, should earn the economic return attributable thereto, left the Service to argue that, notwithstanding the section 351 exchange, the section 936 company was not the true owner of the intangibles, if the Service were going to capture the intangible income in a corporation paying U.S. tax. The Service so argued in *Eli Lilly & Co. v. Comm.*, 84 T.C. 996 (1985).[7] The *Eli Lilly* court ruled that the income with respect to the intangibles transferred to a Puerto Rico affiliate by the U.S. parent corporation (and developer of the intangibles) was earned by the Puerto Rico affiliate from the use of its own property in its own business. That is, the owner of the property rather than the developer was entitled to the economic return thereon.

Briefly, Eli Lilly and Co., Inc. ("Lilly") created a subsidiary in Puerto Rico ("Lilly P.R.") which qualified for the benefits of the predecessor of section 936. In 1966, Lilly transferred patents and related manufacturing know-how for the Darvon products to Lilly P.R. in a tax-free section 351 exchange. During the years 1971-1973, Lilly P.R. manufactured Darvon for sale to Lilly, which in turn marketed the products in the United States. Relying upon section 482, the Service reallocated the income attributable to the Darvon patents and related manufacturing know-how from Lilly P.R. to Lilly. The Service, for purposes of adjusting intercompany prices, ignored the section 351 exchange and permitted Lilly P.R. only a contract manufacturer's profit. In so doing, the Service reallocated all of the profits derived from the intangibles from Lilly P.R. to Lilly. The Service had to make that argument because Revenue Procedure 63-10 looks to ownership of the intangibles and not to the party that developed them.

The Court ruled that the Service had erred in disregarding Lilly P.R.'s ownership of the manufacturing intangibles in determining arm's length prices from Lilly P.R. to Lilly for section 482 purposes. While the Court agreed that the Service could utilize section 482 to reallocate income from property received in a section 351 exchange under the proper circumstances, those circumstances were not present in the case at bar. In this connection, the Court pointed out that the transfer of the intangible from Lilly to Lilly P.R. had been undertaken for bona fide business purposes. Moreover, the Court indicated that taking advantage of the tax benefits provided by Congress in enacting section 351 does not, in and of itself, constitute tax avoidance. However, the Court ruled that the prices Lilly P.R. charged Lilly for the Darvon products were excessive and caused a distortion of income. The Court indicated that in determining arm's length prices, greater weight should be given to Lilly's ownership of the marketing intangibles, to which Lilly had ascribed little value.[8] The Court also noted that the fact that Lilly did not receive consideration for the transferred intangibles (other than an increase in the value of its stock investment in Lilly P.R. which resulted from the section 351 exchange) should be taken into account in establishing arm's length transfer prices under section 482. The Court did this by reducing the transfer prices into the mainland to provide the parent corporation a profit margin which the Court deemed adequate to fund a pro rata allocation of research and development costs. The Court reasoned that in an arm's length transaction, the developer of the patent would not have transferred it to another party without arranging for the payment of a royalty or other cash consideration to help fund ongoing research. That is, a U.S. distributor such as Lilly would not have dedicated its marketing efforts to a product such as Darvon without

7. The Tax Court decision in the *Eli Lilly* case is currently under appeal to the U.S. Court of Appeals for the Seventh Circuit. That decision spans nearly 100 pages in the CCH Tax Court Reporter. An *in extenso* analysis of the *Eli Lilly* decision is beyond the scope of this paper.

8. The analysis of the Court for the year 1973 was quite different. In that year, the Darvon patent had expired. The Court applied an adjusted comparable uncontrolled generic price method.

either a royalty stream or a margin of profit sufficient to help fund research and development.[9] The prices the Puerto Rico affiliate charged to the U.S. parent were adjusted by the Court under section 482 so that a result quite close to a 50/50 profit split between Puerto Rico and the mainland was achieved.

Congress, however, had already acted. TEFRA was enacted while the *Eli Lilly* case was pending in Tax Court. Importantly, TEFRA added the section 936(h) provisions to the Internal Revenue Code.[10] Essentially, section 936(h)(i) provides a general rule that income from intangible property earned by a section 936 corporation will be included in the gross income of its shareholders as income from United States sources, and that such income will not be included in the gross income of the section 936 corporation. That is, the 936 corporation is entitled only to a contract manufacturer's profit. This strict result can be avoided if an election under section 936(h)(5)(F) is made, but under such an election, the Puerto Rico affiliate will not obtain the full tax benefits of owning the intangible property.[11] Under the election, either a cost sharing formula or 50/50 profit split formula will apply. Briefly, under the 50/50 profit split method 50% of the combined taxable income of the section 936 company and its related corporations from the sale of products produced and sold by the 936 corporation will be allocated to the U.S. parent. Under cost sharing, an aliquot share of research and development costs will be born by the section 936 corporation. This has the effect of reducing the parent corporation's section 174 deduction. Under section 936(h)(5)(C)(i)(II), if the cost sharing election is in effect, the section 936 corporation shall be treated as the owner (for purposes of obtaining a return thereon) of the relevant manufacturing intangibles.[12]

FOREIGN COUNTRIES

The theory behind technology transfers to foreign corporations in low-tax or tax holiday jurisdictions was quite similar to pre-TEFRA Puerto Rico transfers. That is, pursuant to the logic of Revenue Procedure 63-10, in order for the foreign affiliate to be able to justify earning all of the income from the intangible property, it had to be the owner thereof. Ownership could be transferred by sale (including a permanent and exclusive license).[13] Alternatively, ownership could be transferred by way of a section 351 exchange. The sale method was not much utilized because it produced a U.S. tax for the transferor.[14] The proceeds of the sale could not qualify for capital gains treatment pursuant to the recharacterization rule of section 1249. That section provides that gain from the sale or exchange of any specified intangible property to any foreign corporation by a United States person which controls the transferee shall, if it would otherwise qualify for capital gains treatment (including section 1231), be considered to be ordinary income.[15] Since the basis of the intangible was likely to be nearly zero due to the deductions permitted under section 174, taxable sales were not favored by industry since the tax cost would be high.

The favored method of transfer was a tax free exchange under section 351. Since (unlike the section 936 corporation in the case of Puerto Rico) the transferee was a foreign corporation and the transferor was a U.S. corporation, the section 351 exchange constituted an outbound transaction under section 367(a). In order to achieve tax free treatment the transferor had to obtain a ruling from the Service that the exchange was not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes. Typically, the exchange would be made in consideration of actual or constructive receipt of the shares of the transferee.[16]

The Service issued guidelines in 1968 as to when favorable rulings would usually be issued. The guidelines are set forth in Revenue Procedure 68-23.[17] The relevant general rule contained in the guidelines concerning section 351 transfers to foreign corporations controlled by the transferee is that it is permissible to transfer property which will be devoted by the transferee foreign corporation to the active conduct of a trade or business in any foreign country and still receive tax-free treatment of the transfer, provided the foreign corporation would require a substantial investment in fixed assets in its business. There are exceptions to the general rule, inter alia, in the case of dealer property under section 1221(1), "personal efforts" property under section 1221(3) and property where it is reasonable to believe that the sale or other disposition thereof by the transferee foreign corporation is one of the principle purposes of its transfer. Furthermore, under the guidelines, there could be no tax-free transfer to a foreign corporation of a U.S. patent, trademark, or similar intangibles for use in the conduct of a U.S. trade or business or for use in manufacturing

9. This position is questionable because it holds that an exchange of patent rights for stock would never take place at arm's length. Yet, commercial realities are such that an equity transfer is not novel. Moreover, this position is at odds with the Service's position that the tax benefit rule does not apply, to recapture as ordinary income, gain resulting from the disposition of technology produced from research and experimentation, the costs of which had been previously deducted under section 174. Revenue Ruling 85-186, 1985-46 I.R.B.G. Additionally, the position ignores an excellent source of funds for the parent's R&D program; that is, dividends from Puerto Rico. Unlike royalties, such dividends would not be subject to U.S. tax because of the dividends received deduction. As such, dividends would, in fact, better fund research than would royalties.

10. TEFRA section 213(a).

11. See General Explanation of the Revenue Provision of the Tax Equity and Fiscal Responsibility Act of 1982 86; prop. regulation section 1.936-4.

12. Under either the 50/50 profit split or the cost sharing elections, actual ownership of the intangible property by the section 936 corporation is irrelevant.

13. SeeParke Davis & Co. v.*Comm.*, 31 B.T.A. 427, 431 (1934); cf. *Waterman* v. *Mackenzie*, 138 U.S. 252 (1891).

14. The author is unaware of any such transaction in the pharmaceutical industry. Perhaps the only reason for engaging in such a transaction would be to utilize an expiring excess foreign tax credit under section 904.

15. Of course, such property would first have had to qualify as a capital asset or section 1231(b) property.

16. Section 367(c)(2).

17. 1968-1 C.B. 821, amplified by Revenue Procedure 80-14, 1980-1 C.B. 617.

in the U.S. or abroad for sale into the U.S. Therefore, however, by negative implication, transfers of foreign intangibles for use in the active conduct of a foreign trade or business qualified for tax free treatment. The Service routinely issued favorable rulings in such circumstances.[18]

By 1984 Congress was sufficiently dissatisfied with this state of affairs to change the operative rules by enacting TRA 1984. The General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984 (hereinafter, "TRA 1984 General Explanation") discusses this problem in listing the Reasons for Change.

> Under its published ruling guidelines, the IRS generally issued favorable rulings for transfers of patents and similar intangibles for use in an active trade or business of the foreign transferee corporation. The only exceptions were transfers of certain intangibles used in connection with a U.S. trade or business or in connection with goods to be manufactured, sold or consumed in the United States. In light of this favorable ruling policy, a number of U.S. companies adopted a practice of developing patents or similar intangibles at their facilities in the United States, with a view towards using the intangibles in foreign operations. When these intangibles were ready for profitable exploitation, they were transferred to a manufacturing subsidiary incorporated in a low-tax foreign jurisdiction (or in a high-tax jurisdiction that offered a tax holiday for specified local manufacturing operations). By engaging in such practices, the transferor U.S. companies hoped to reduce their U.S. taxable income by deducting substantial research and experimentation expenses associated with the development of the transferred intangible and, by transferring the intangible to a foreign corporation at the point of profitability, to ensure deferral of U.S. tax on the profits generated by the intangible.
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> TRA 1984 General Explanation, 427.

Section 131(b) of TRA 1984 amended section 367(d) to provide that where specified tangible property [as defined in section 936(h)(3)(B)] is transferred to a foreign corporation in an exchange described in section 351 or 361, then a rule similar to, but broader-reaching than section 1249 recharacterization will apply.[19]

Pursuant to section 367(d)(2)(A) the transferor is to be treated as having made a sale of the property in exchange for payments which are contingent upon the productivity, use, or disposition of the intangible property. The transferor will be deemed to have received payments which reasonably reflect the amounts that would have been received under an agreement calling for annual payments. These amounts are to be treated as ordinary income (the section 1249 result). Unlike section 1249, section 367(d) contains a sourcing rule. Section 367(d)(2)(C) provides that such ordinary income will be treated as U.S. source ordinary income. Section 1249 merely characterizes the income as ordinary. In section 1249 cases where contingent payments are called for, the source of the income is based upon where the property is used. That is, it is based on the royalty sourcing rule.[20] In section 1249 cases where a lump sum is paid, the sourcing rule is based upon the passage of title test.[21] Thus, in cases where the taxpayer is in an excess foreign tax credit position under section 904, the section 367(d) outcome is more costly to the taxpayer than the section 1249 outcome. Additionally, section 367(d)(2)(A)(ii)(II) reaches gains on the disposition of the property by the foreign corporation or a disposition of the foreign corporation itself.[22]

Possible taxpayer responses to section 367(d) could include such items as entering into bona fide cost sharing arrangements pursuant to regulation section 1.482-2(d)(4). Of course, the amount of deduction available to the U.S. taxpayer under section 174 will be ratably decreased. Additionally, patent applications for property still in an early stage of development can be transferred in a section 1249 transaction (or a section 367(d) transaction if the taxpayer is indifferent to whether the deemed royalty income is U.S. or foreign source). Since the value of such uncommercialized technology is generally speculative, presumably a generally prevailing industry royalty rate would be in order. The theory behind these approaches would be that the foreign corporation was bearing its share of the financial risk of commercial failure, and therefore was entitled to a risk-taker's profit. In either the cost sharing arrangement under regulation section 1.482-2(d)(4), or the transfer of early stage, uncommercialized technology, the foreign corporation would be required to expend its own funds for development purposes, and perhaps would have to make significant capital expenditures with no guaranty of having obtained a commercially successful product.

PROPOSED LEGISLATION

Against this background, sections 641(a)(1)(B) and 641(e) of TRA 1985 can be analyzed. These provisions would effect further restrictions on international technology transfers. Section 367(d)[23] would provide that the payments which are deemed to have been received by the transferor must be "commensurate" with the income attributable in actual experience to the intangible property. Also, in the case of licenses or sales of technology, similar rules are to apply for purposes of section 482. Note that this test differs from regulation section 1.482-2(d)(2)(iii)(g) which looks to *prospective* profits. Moreover, the cost sharing formula for a section 936 corporation under section 936(h)(5)(C)(i)(I) is amended to provide that the cost sharing payment must be at least as large as the section 367(d) deemed royalty payment, which now would reflect the amendment thereto.

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18. E.g. PLR 8404026; PLR 8405004; PLR 8405113.
19. A good discussion of the section 367(d) mechanism can be found in Meyer, Taxation of Intellectual Property: Foreign Aspects 38 *The Tax Executive* 127 (1986).
20. See sections 871(e)(2), 861(a)(4), 862(a)(4).
21. *Comm.* v. *Celanese Corp. of America*, 140F2d. 339 (D.C. Cir. 1944).
22. TRA 1984 General Explanation, 433.
23. TRA 1985 would enact the Internal Revenue Code of 1985. Accordingly, unless otherwise stated, in this discussion of TRA 1985 references to "sections" are to sections of the Internal Revenue Code of 1985.

The Ways and Means Committee Report leaves little doubt but that payments are to be adjusted periodically to reflect actual income experience rather than the forecasts at the time of transfer:

> The committee does not intend, however, that the inquiry as to the appropriate compensation for the intangible be limited to the question of whether it was appropriate considering only the facts in existence at the time of the transfer. The committee intends that consideration also be given the actual profit experience realized as a consequence of the transfer.
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> House Ways and Means Committee Report on H.R. 3838, "Tax Reform Act of 1985" (hereinafter, "TRA 1985 Report") 425.

Where a product is unexpectedly profitable, it is clear that the royalty payments back to the U.S. must be increased. One may suspect that there will be little zeal on the part of the Service to adjust royalties downward where a product turns out to be significantly less profitable than originally expected, or where a once popular product begins to falter.

In cases where the transferee sells its products to other affiliates, the TRA 1985 Report hints that a contract manufacturer's profit is all that the technology transferee should earn:

> In requiring that payments be commensurate with the income stream, the bill does not intend to mandate the use of the "contract manufacturer" or "cost-plus" methods of allocating income or any other particular method. As under present law, all the facts and circumstances are to be considered in determining what pricing methods are appropriate in cases involving intangible property, including the extent to which the transferee bears real risks with respect to its ability to make a profit from the intangible or, instead, sells products produced with the intangible largely to related parties (which may involve little sales risk or activity) and has a market essentially dependent on, or assured by, such related parties' marketing efforts. However, the profit or income stream generated by or associated with intangible property is to be given primary weight.
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> TRA 1985 Report, 426

The intent to depart from the normal section 482 rules, which are based on the internationally recognized arm's length standard, is clear:

> In making this change, the committee intends to make it clear that industry norms or other unrelated party transactions do not provide a safe-harbor minimum payment for related party intangible transfers. Where taxpayers transfer intangibles with a high profit potential, the compensation for the intangibles should be greater than industry averages or norms. In determining whether the taxpayer could reasonably expect that projected profits would be greater than the industry norm, the committee intends that there should be taken into account any established pattern of transferring relatively high profit intangibles to Puerto Rico or low tax foreign locations.
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> TRA 1985 Report, 425

Under the proposed legislation the arm's length standard of current law section 482 would be dropped in favor of what could be called "arm's length plus". The courts would seem to be able to police interaffiliate payments where the transferred technology is unusually valuable. Where a U.S. taxpayer licensed in technology from its foreign affiliate a royalty payment at a rate of 10% rather than the industry norm of 5% was held to be valid against a section 482 challenge in *Ciba-Geigy Corp v. Comm.*[24]

In conclusion, the proposed legislation would depart from the arm's length standard when royalties are to be paid into the United States, while at the same time, the arm's length standard would continue when royalties are to be paid out of the United States. One can expect numerous situations where international double taxation will arise if the current legislative proposals are adopted. Given the departure from international norms, it is unlikely that Competent Authority proceedings under the various tax treaties will provide the U.S. taxpayers with any meaningful relief. Moreover, it would appear likely that the new arm's length plus standard will encourage litigation in the Puerto Rico cost-sharing formula context of the kind which the enactment of the cost-sharing formula was intended to avoid.

24. 85 T.C. 172 (1985).

U.S.A.:

Life after Rev. Rul. 84-152

Treaty Shopping: Recent U.S. Developments

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The reasons for, and the efforts of, the United States to limit benefits under its bilateral income tax treaties in recent years have been well documented.[1] Recently, the United States Internal Revenue Service (the "Service") issued two public revenue rulings[2] which have further reinforced the position that the United States has taken against treaty shopping. This paper will review these rulings in the context of the basic U.S. policies relating to treaty shopping.

I. BACKGROUND

The United States views a tax treaty as a bilateral agreement designed to benefit directly the residents of the two contracting states and not to provide indirect benefits to residents of third states. Thus, the United States views the ability of third country nationals to derive treaty benefits by interposing an appropriately selected treaty protected entity to minimize source basis taxation, i.e. treaty shopping, as a practice which should be limited. As a result, the United States has established a firm policy of including in all of its income tax treaties a limitation of benefits article which is intended to deny benefits to residents of our treaty partners who are not justifiably entitled to such benefits.[3]

The exact form of the limitations of benefit article will vary from treaty to treaty, according to the perceptions of the contracting parties relating to the potential for abuse, given the internal laws of the two contracting states and the substantive provisions of the treaty.

Generally, two types of provisions may be expected to be included in a limitation of benefits article. The first relates to the beneficial ownership of the treaty protected entity. If third country nationals own above a certain percentage, e.g. more than 50% of the treaty protected entity and subject to certain exceptions,[4] treaty benefits (either all benefits or the benefits of the dividends, interest, royalties and capital gains articles) will be denied.

The second relates to what has been commonly referred to as "base erosion". In this case, a third country national will establish an entity, normally a company, in one of the contracting states (the host country) to invest in the other (the source country). The host entity will be structured in a manner that permits it to make large payments of otherwise deductible amounts as determined under the laws of the host country, to third country nationals, thereby reducing the treaty protected entity's taxable income in the host country to a relatively insignificant amount on the "spread", i.e. the differences between the income received and the deductible payments. If the treaty protected entity can make these deductible payments, e.g. interest, from the host country without incurring a substantial tax because that country imposes little or no withholding liability, the third country national will have minimized its overall tax by obtaining through this structure treaty benefits from the source country and paying little or no tax to the host country. This type of structure may be utilized so as to avoid failing to satisfy the ownership tests of a limitation of benefits rule, for example, by causing the equity owner of the treaty protected entity to be a resident of the host country, while the third country national (the principal beneficiary of the plan) contributes large amounts of loan capital. To prevent utilization of this type of structure, a rule is provided whereby an entity which is a resident of one contracting state which receives income from the other contracting state is not entitled to treaty benefits with respect to income used in substantial part to meet liabilities to third country nationals.

Other types of anti-abuse provisions are utilized as appropriate.

The reasoning underlying the United States policy can be summarized as follows:

1. See e.g. Tax Treaties, Hearings Before the Committee on Foreign Relations, United States Senate, 97th Cong., 1st Sess. (September 24, 1981).
2. Rev. Rul. 84-152, 1984-2 C.B. 381; Rev. Rul. 84-153, 1984-2 C.B. 383.
3. The United States recognizes that this article will be given reciprocal effect by our treaty partners and thereby will cause the denial of treaty benefits to U.S. residents.
4. Exceptions may relate to corporations whose shares are traded on a recognized exchange in a contracting state and to entities, regardless of their ownership, who are formed (or acquired) and operated for legitimate business purposes and not primarily for the purpose of deriving treaty benefits, i.e. the limitation of benefits article is not intended to inhibit legitimate commercial activity.

1. A limitation of benefits provision permits the United States to expand its income tax treaty network to countries with which it does not have a treaty and also to renegotiate its existing treaty network, hopefully on more favorable terms. In a tax treaty generally both contracting states make source basis tax concessions. If residents of states that do not have U.S. tax treaties, or have U.S. tax treaties with less favorable provisions, can treaty shop to obtain U.S. source basis tax benefits, then there is a potential lack of reciprocity for both U.S. taxpayers and the U.S. government. This lack of reciprocity arises because while a resident of a third country may be able to derive U.S. tax benefits through the interposition of a treaty protected entity, a U.S. taxpayer may not be able to obtain tax benefits from such country through treaty shopping. This lack of reciprocity may cause such country to be under less pressure to enter into a treaty with the United States with the consequence that the U.S. government loses revenue as a result of a reduction of its tax on U.S. source income earned indirectly by a resident of such country and because of U.S. taxpayers claiming a foreign tax credit for the amount of local taxes on income from source within such country. The lack of reciprocity denies the U.S. business community the benefits which they would receive from an expanded U.S. tax treaty network.

If residents of a third country can no longer obtain U.S. tax benefits indirectly through treaty shopping, there may be more of an incentive for such country to negotiate a tax treaty with the United States. A similar rationale applies to the renegotiation of existing tax treaties in situations where, for example, a resident of a treaty partner of the United States can obtain more favorable benefits than under that country's bilateral income tax treaty with the United States by interposing an appropriately selected treaty-protected entity to invest in the United States, while U.S. residents cannot in the reciprocal situation obtain similar advantageous benefits.[5]

2. A limitation of benefits provision assures that tax treaty benefits flow only to the intended beneficiaries. As indicated above, a tax treaty is negotiated on a bilateral basis to, inter alia, eliminate double taxation when a resident of one contracting state derives income from sources within the other contracting state. It would be beyond the basic purpose of a bilateral tax treaty to allow third country nationals who do not have a significant economic and tax nexus with a contracting state to use a treaty to claim source basis tax benefits from the other contracting state. Where such third state use is tolerated or otherwise results from an unintended application of a bilateral income tax treaty, it frequently results in elimination of all taxation, not merely the elimination of double taxation. In these circumstances, there appears to be no justification for reducing or eliminating source basis taxation.

3. A limitation of benefits provision assures that important U.S. tax policy judgments are made by the United States. In its recent negotiation of tax treaties, the United States Treasury Department has adhered to the precept that bilateral income tax treaties should generally not deviate materially from the provisions contained in the Internal Revenue Code. It is the policy judgment of Congress that frames the Internal Revenue Code. To the extent that treaty shopping is permitted, third country nationals may be able to obtain benefits deviating from the provisions contained in the Internal Revenue Code and contrary to the intent of Congress. Thus, the coherence of the Internal Revenue Code is subverted. Moreover, to the extent that third country nationals can obtain unintended benefits, the perception of the United States tax system as being easy to manipulate, especially by the well advised and wealthy, is enhanced.

For the reason stated above, and notwithstanding arguments to the contrary, the United States has established a firm policy of including in all its income tax treaties a limitation of benefits provision.

The rulings

Though the Treasury Department is the agency delegated the responsibility for negotiating bilateral income tax treaties, it is the Service that administers such treaties once they are negotiated. In its administration, the Service will, from time to time, issue revenue rulings[6] which interpret a variety of the provisions contained in a treaty. It is in this capacity that the Service issued the two rulings described below.[7]

The first of these, Revenue Ruling 84-152,[8] involves the following fact pattern in an "inbound" transaction. A Swiss corporation owns 100 percent of the stock of a Netherlands Antilles corporation, which corporation is engaged in the conduct of a business within the Netherlands Antilles. The Swiss corporation also owns 100 percent of the stock of a domestic corporation engaged in manufacturing in the United States. Neither the Netherlands Antilles corporation nor the domestic operating corporation is thinly capitalized. The domestic operating corporation is in need of a significant increase in working capital for purposes of upgrading its production facilities. To fund that need, the Swiss corporation lends the Antilles corporation (which would not have had sufficient liquidity to make a loan to the domestic operating corporation if its Swiss parent had not advanced such amount) an amount of money approximating the funds required

5. A limitation of benefits provision should also result in a concomitant improvement in the administration of the U.S. tax system. Generally, the most effective means for the United States to obtain or transmit information relevant to taxation or implement equitable remedies, such as through a treaty's mutual agreement procedure to eliminate taxation, is through tax treaties. If residents of a third country can, through treaty shopping, achieve the substantive and procedural benefits available under tax treaties, or if residents of the United States can treaty shop to obtain similar benefits from another country, the administration of the U.S. tax system will suffer because there will be no direct exchange of information.

6. A revenue ruling, in effect, is the opinion of the Service as to the Internal Revenue Code's consequences as applied to a particular factual situation. A ruling can be declared invalid by a court.

7. The Treasury Department is not, however, excluded from the process relating to the issuance of public revenue rulings.

8. See GCM 37940 (April 24, 1970).

by the domestic operating corporation at an annual interest rate of 10 percent; the Antilles corporation, in turn, reloans the proceeds to the domestic operating corporation at an annual interest rate of 11 percent. Thereafter, the domestic operating corporation makes timely interest payments to the Antilles corporation, who, in turn, makes timely interest payments to the Swiss corporation. Excess revenues with respect to the financing arrangement (after expenses) are retained by the Antilles corporation for its own purposes.

The ruling considers whether the Antilles corporation is entitled to the benefits of the Netherlands Antilles treaty exemption[9] with respect to the interest paid by the domestic operating corporation to the Antilles corporation.[10] (For this purpose, the ruling states as a fact, that the Antilles corporation has made the appropriate elections under the internal law of the Antilles, to obtain the benefits of the interest exemption under the relevant Article of the Antilles treaty.)

The ruling holds that the interest payments made by the domestic operating corporation are not exempt from U.S. taxation under the Antilles treaty and are subject to the 5% rate of withholding under the Swiss-United States Income Tax Treaty ("Swiss treaty").

The Service cites two cases, *Aiken Industries, Inc.* and *Gregory v. Helvering,* discussed infra, in reaching its conclusion that for purposes of the Antilles treaty, interest must be "derived . . . by" the Antilles corporation from the domestic operating corporation for it to be exempt under the treaty. The Service (reflecting language found in Aiken), indicates that the words "derived . . . by" refer not merely to the Antilles corporation temporarily obtaining physical possession of the interest paid by the domestic operating corporation, but to the Antilles corporation obtaining complete dominion and control over such interest payments. Under the facts of the ruling, the Service finds that, in substance, the Antilles corporation never had such dominion and control over the interest payments but acted merely as a conduit for the passage of such interest payments to its Swiss parent.

Though the ruling does not describe the terms of the loans between the respective parties, the Service indicates that the primary purpose for involving the Antilles corporation in the transaction was to obtain the benefits of the Antilles treaty, which provides for a zero rate on certain interest income from U.S. sources, thereby avoiding the imposition of the 5% U.S. withholding tax which would have been imposed under the Swiss treaty. The Service held that its conduit approach applied notwithstanding that it can be demonstrated that routing the loan through the Antilles may serve some business or economic purpose. The Service disregarded the particular transaction, noting that the use of the Antilles entity lacked sufficient business or economic purpose to overcome the conduit characterization of the transaction.

The second Revenue Ruling 84-153, issued on the same date, involves a similar fact pattern in an "outbound" transaction involving the common situation of a U.S. corporation seeking access to foreign capital markets through the interposition of a Netherlands Antilles international finance subsidiary. Essentially, the facts reflect the traditional international finance subsidiary structure in that a U.S. corporation owns 100% of the stock of a Netherlands Antilles corporation. It is assumed under the ruling that theAntilles corporation is properly capitalized. The U.S. corporation also owns all of the stock of a domestic operating company which is in need of funds. In furtherance of the transaction, the Antilles company issues bonds through a public offering and reloans the proceeds to the domestic operating company at a rate of interest 1% in excess of the rate of interest that it is obligated to pay to its foreign bond holders. The facts assume that timely interest payments are made by the parties to the transaction and that excess revenue, after expenses generated by the Antilles company, are retained by it.

The Service, in nearly identical language as used in Revenue Ruling 84-152, uses the same reasoning as stated above to disregard the form of the transaction and characterize it, in effect, as if the interest payments were made by the U.S. company to the ultimate foreign bond holders. It cites the same authorities, namely *Aiken* and *Gregory v. Helvering,* in reaching its conclusion.[11]

Apart from the substantive holdings of these rulings, the timing of the issuance of the two rulings is of interest itself and in the context of the substantive issues raised. First, though it had been rumored that at least one of the rulings had been pending at the Service for some time, issuance of these rulings prior to the repeal of the 30% U.S. tax[12] would potentially have created havoc in the international capital market since U.S. issuers seeking access to foreign capital markets have historically utilized interposed treaty protected international finance subsidiaries, usually incorporated in the Netherlands Antilles, to gain access to such markets. Had the ruling or rulings been issued prior to the repeal of the 30% tax, many U.S. issuers perhaps would have redeemed the obligation

9. Under the Netherlands-United States Income Tax Convention, as extended to the Netherlands Antilles ("Antilles treaty"), there is an exemption from U.S. tax on U.S. source interest paid to an Antilles corporation provided certain conditions are satisfied. More specifically, Article VIII of the Antilles treaty provides in pertinent part:

> Interest . . . derived from sources within the United States by a resident or corporation of the Netherlands Antilles not engaged in trade or business in the United States through a permanent establishment shall be exempt from United States tax . . . .

10. The interest paid under the facts of this ruling would not be eligible for exemption under the repeal of the 30% tax with respect to certain interest paid to foreign persons, as enacted by section 122 of the Tax Reform Act of 1984. § 881(c)(B).

11. The ruling sidesteps the difficult issue of who is the true obligor of the obligations by not stating that the international finance subsidiary debt is guaranteed and furthermore indicates that similar types of arrangements may also involve other issues relating to the true nature of a debt obligation issued by an international finance subsidiary. Again, the facts of the ruling assume the inapplicability of the section repealing the 30% tax of certain interest payments to foreign persons.

12. The 30% tax was repealed effective for qualifying obligations issued after 18 July 1984.

of their international finance subsidiary to avoid future obligation to "gross up" for the U.S. tax.[13] Large scale redemptions would not have gone unnoticed in international capital markets and one consequence could have been upward pressure on interest rates. With the passage of the repealer, this is no longer a concern.

Second, the repealer contained an unusual provision "grandfathering" various Eurobond transactions effected prior to a certain date, provided certain conditions are satisfied. This was done to deal with the ever increasing number of audits of international finance subsidiaries. Notwithstanding the audits, certain U.S. multinationals continued to utilize international finance subsidiaries after the Congress had agreed to the repeal of the 30% tax, but prior to entry into force of the new law. So too, certain issuances were effected even after entry into force of the new law. Thus, by issuing these rulings at the time they did, the Service seems to be stating its position that, with the passage of the repealer, direct access should be encouraged and indirect access through a treaty protected entity should be discouraged.[14]

Third, and perhaps most significant, since the Eurobond market after the repealer would not be affected except as otherwise stated above, the Service presumably felt it appropriate to attack head-on the common type of back to back treaty shopping transaction. Thus, from the government's point of view, there may have been no reason why these rulings should not have been issued, obviously premised on the basis that the government felt that its position was conceptually correct.[15]

Substantively, these two rulings have far ranging implications in that they go beyond the rationale of the currently outstanding precedents relating to overturning treaty shopping structures. Further, it is unclear how these rulings affect other rulings which were neither cited in these two rulings, nor revoked or modified by such ruling.

When issued, the two rulings applied retroactively, as well as prospectively; thus, many structures created in the past could have been vulnerable to attack under the rationale of these rulings. However, very recently the Service in Rev. Rul. 85-163[16] stated that the two rulings would not be applied retroactively; i.e. would not apply to interest payments made in connection with debt obligations issued prior to 15 October 1984, the date that Rev. Rul. 84-152 and Rev. Rul. 84-153 were published in the Internal Revenue Bulletin, and to interest payments made in connection with debt obligations issued on or after 15 October 1984, pursuant to a binding written agreement entered into prior to 15 October 1984, including debt obligations issued in 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.[17]

The discussion below will first review in general terms the various arguments that the Service has in the context of treaty shopping in general. Second, the two rulings' effect on outstanding precedents will be considered.

II. PRECEDENTS

A. Disregard of interposed treaty shopping vehicle as a separate entity

In the past, the Service has from time to time argued that the interposed, treaty-protected entity created is, in essence, a sham and should be disregarded for tax purposes as a separate entity. The result of this characterization is to treat the ultimate foreign investor as receiving the income directly.

This argument has generally not been accepted by the courts because U.S. precedents relating to when an entity should be disregarded have been narrowly construed.

More significantly, the basic test referred to by the courts in determining whether the separate existence of a corporation should be given effect for tax purposes was set forth by the Supreme Court in *Moline Properties, Inc. v. Commissioner.*[18]

> The doctrine of corporate entity fills a useful purpose in business life. Whether the purpose be to gain an advantage under the law of the state of incorporation or to avoid or to comply with the demands of creditors or to serve the creator's personal or undisclosed convenience, so long as that purpose is the equivalent of business activity or is followed by the carrying on of business by the corporation, the corporation remains a separate taxable entity. (Footnotes omitted).

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13. Under the typical international finance subsidiary structure, there is a provision whereby the issuer undertakes to pay interest to qualifying recipients net of U.S. income tax. To the extent U.S. tax is imposed, the issuer further undertakes to pay such tax, which equates to a potential 43% additional interest cost.

14. In fact, that was one of the reasons stated for passage of the repealer. Further, the Conference Report with respect to this amendment instructed the Service to look closely at back to back transactions.. H.R. Rep. 98-861, 98th Cong., 2d Sess. 937-38 (1984).

15. The House of Representatives, in one of the provisions ultimately enacted in the Tax Reform Act of 1984, made the following comment:

> The committee is aware that some foreign investors seek to use conduit corporations organized outside their home countries, in tax treaty partner countries of the United States, to avoid U.S. tax. For instance, under the current income tax treaty with the Netherlands Antilles, an investor from a country with which the United States has no treaty may lend money to a conduit corporation in the Netherlands Antilles, which might relend to a U.S. corporation, and the United States might collect no tax. The committee understands that the Treasury Department has adopted a policy, to be implemented in current and future income tax treaty negotiations, that would limit treaty benefits to bona fide residents of the treaty country. The committee urges the Treasury Department to continue that policy and to insist on such a result in treaty negotiations.

H.R. Rep. 98-432 (Part 2), 98th Cong., 2d Sess. 1343 (1984).

The Service might have found the above quoted sentiment useful in its deliberation to issue these rulings.

16. 1984-41 I.R.B.

17. Prior to Rev. Rul. 85-163, the retroactivity of the rulings, especially the "inbound" ruling, raised the issue of whether affected persons could have claimed relief under section 7805(b), which, in effect,, would have applied the holdings of the rulings prospectively (and not retroactively), based on an argument relating to reliance on the then state of the law. Prior to the publication of Rev. Rul. 85-163, the Service had agreed only to taxpayers filing requests for such type of relief with respect to the "outbound" ruling. See Treasury Department News Release, dated 18 October 1984. See e.g. PLR 8525031 (22 March 1985) referring to PLR 8520055 (19 February 1985), where the Service granted section 7805(b) relief.

18. 336 U.S. 422 (1949).

This test appears to be framed in the alternative in that either business purpose or business activity will suffice.[19] The quantum of business activity required is unclear, but the cases indicate that it may not have to be significant. "Minimal activity, such as signing leases, issuing a mortgage, or maintaining a bank account will be enough to constitute 'business activity' within the meaning of the Moline test."[20] In *Moline* itself, the corporation was created to hold realty previously owned by its sole shareholder; its existence was recognized, based on activities consisting of the assumption of a mortgage, the short term net leasing of property and the sale of property it held.[21]

Corporations have been disregarded where the court found no business purpose for the existence of the corporation, coupled with a tax avoidance motive for creating the corporation *Lloyd F. Noonan*.[22] However, in general, a tax avoidance motive will not be sufficient to cause the corporation to be disregarded if there is some business purpose or activity.[23]

In fact, in Bass, supra, the Service asserted that the Swiss corporation utilized by the U.S. taxpayer to hold U.S. oil and gas interests was formed for the sole purpose of avoiding U.S. taxes and therefore should be disregarded. The court rejected such contention, based on the activities of the corporation while specifically not deciding whether the Swiss corporation was entitled to the benefits of the Swiss treaty. It stated:

> The test, however, is not the personal purpose of taxpayer in creating a corporation. Rather, it is whether that purpose is intended to be accomplished through a corporation carrying out substantive business functions. If the purpose of the corporation is to carry out substantive business functions or if it in fact engages in substantive business activity, it will not be disregarded for Federal tax purpose.[24]

An additional factor that has been considered by the courts as evidence of separate corporate existence is the observance of corporate formalities, such as maintaining an office, a bank account, and adequate books and records, holding required meetings, and filing tax returns (foreign as well as domestic, where appropriate).[25]

B. Treatment of treaty protected entity as a conduit or an agent for its foreign owners

An alternative and more effective attack of a treaty shopping structure is that the entity is not in substance the beneficial owner of the income received from the source state, but rather is acting in the capacity of a conduit for its ultimate foreign investor. This argument can be made by reference to precedents applicable in both the Internal Revenue Code and treaty contexts. The effect of this argument is not to disregard the treaty protected entity, but to treat the income received by such treaty protected entity in a capacity as a conduit for the ultimate foreign investor.

Primary support for a Service challenge on this basis is found in the opinion of the Tax Court in *Aiken Industries, Inc.*[26] (the case that was prominently cited in the two rulings). In that case, a parent corporation organized in the Bahamas (which has no tax treaty with the United States) made an interest bearing loan to its U.S. subsidiary. Under the Internal Revenue Code, interest payments by the subsidiary to its parent would have been subject to the 30% U.S. tax. Shortly before the first payment was due, the parent transferred the U.S. corporation's notes to a newly-created affiliate created under the laws of Honduras in exchange for notes of the Honduran corporation, which were essentially identical to the U.S. corporation's notes (i.e. in face amount and interest rate). In the years at issue, Honduras had entered into an income tax convention with the United States which, if certain conditions were met, exempted the qualifying Honduran recipient from the 30% U.S. tax on U.S. source interest income.[27]

The issue before the court was whether the Honduran entity was entitled to claim the benefits of the Honduran treaty in the subject circumstances. The court, as indicated above, first found that the terms of the treaty compelled a finding that the separate existence of the Honduran corporation should be recognized under the applicable treaty.

However, the court then indicated that it had the right under the treaty to assign to those terms "not other-

19. Some cases have held that the corporation should cease to be regarded as a separate entity once its business activities have been discontinued. See e.g. *National Investors Corp. v. Hoey*, 144 F.2d 466 (2d Cir. 1944) (subsidiary which was formed to hold securities to facilitate a consolidation was treated as a separate corporation only as long as plan of consolidation was proceeding, but not after the plan was abandoned); *Minnesota Farm Bureau Securities, Inc. v. U.S.*, 63-1 USTC para. 9138 (D. Minn. 1962) (subsidiary originally formed to raise funds for parent held to be a "conduit" and not separately taxable in a later "year of passive business purpose").
20. Kronovet, "Straw corporations: When will they be recognized; what can and should be done", 39 J. Tax 54, 55 (1973).
21. Other activities which have been held sufficient for this purpose are: investing in a joint venture or partnership and receiving the profits therefrom (*Sam Siegel*, 45 T.C. 566 (1966); *George Cukor*, 27 TCM 89 (T.C. Memo. 1967-17); *Britt v. U.S.*, 432 F.2d 227 (5th Cir. 1970); but cf. *Davis*, 29 TCM 749 (T.C. Memo. 1970-170)); obtaining a secured loan, although no office and no bank account (*Paymer v. Commissioner*, 150 F.2d 334 (2d Cir. 1945)); holding a lease on behalf of a partnership (*Stillman*, 60 T.C. 897 (1973)); financing the purchase of and leasing property immediately transferred to shareholders subject to lease and mortgage for no consideration (*David F. Bolger*, 59 T.C. 760 (1973)); holding an individual working interest in oil and gas leases subject to operating agreements (essentially a passive investment) (*Perry R. Bass*, 50 T.C. 598 (1968)); and handling of licenses for patent rights by dummy director who acted solely on the instructions of affiliated corporations (*Photocircuits Corp. v. U.S.*, 742 U.S.T.C. ¶ 9558 (Ct. Cl. 1974).
22. 52 T.C. 907 (1969); Davis, supra.
23. See also Siegel, supra.
24. 50 T.C. at 601. So too, in *Aiken Industries, Inc.*, infra, the court, on the basis of the language contained in the Honduran treaty, felt compelled not to uphold the Service's argument that an entity organized under a tax treaty should be disregarded as a sham.
25. *Bass*, supra; *Ross Glove Company*, 60 T.C. 569 (1973), acq. 1974-2 C.B. 4.
26. 56 T.C. 925 (1971).
27. Article IX of the treaty (which is no longer in force), provided in part:
    Interest . . . from sources within one of the contracting states received by a . . . corporation or other entity of the contracting state not having a permanent establishment within the former state . . . shall be exempt from tax by such former state.

wise defined" by the treaty the meanings which would normally attach to such terms under U.S. law. In making this statement, the court noted "that the fact that the actions taken by the parties in this case were taken to minimize their tax burden may not by itself be utilized to deny a benefit to which the parties are otherwise entitled under the convention",[28] citing *Gregory v. Helvering*.[29]

Based on the facts of the transaction being considered, the court held that the Honduran entity was acting as a mere conduit in that it was committed to pay out exactly what it collected as interest and thus that its role in the transaction should be ignored.[30] It characterized the Honduran corporation as no more than a "collection agent" with respect to the interest received from its U.S. affiliate.[31]

The court premised its holding on the language contained in the Honduran treaty, and found that the interest payments in question were not "received by" the Honduran entity within the meaning of the treaty.

> As utilized in the context of Article IX [of the treaty], we interpret the terms 'received by' to mean interest received by a corporation of either of the contracting States as its own and not with the obligation to transmit it to another. The words 'received by' refer not merely to the obtaining of physical possession on a temporary basis of funds representing interest payments from a corporation of a contracting State, but contemplate complete dominion and control over the funds.[32]

Thus, by applying U.S. standards, the court found that the Honduran entity was not the beneficial owner of the interest and thereby was not entitled to the treaty benefit. This holding can be generalized to confirm a basic treaty concept that treaty benefits only extend to the beneficial recipient and not to its agent.

From the foregoing precedents, it can be seen that the Service in the two revenue rulings has opted to attack a back to back treaty shopping structure on the basis of a conduit rather than a sham type of argument. However, has the Service correctly applied *Aiken* to the situations posited in the rulings?

As indicated above, *Aiken* involved an easy case for applying a conduit approach. In the case of the two rulings, the omission of the terms of transaction, other than the rates of interest, raises a number of questions. Since the rulings do not describe the terms, it is unclear whether a back to back transaction must be proximate in time or amount, or morely require the obligation for a payment of a portion of the funds received. It would appear that the rulings cannot stand for the proposition that all back to back transactions can be ignored as conduits.[33] If that is true, when will a transaction be upheld or disregarded? This determination would appear to require an examination of the facts and circumstances. Such factors as potential for profit, risk of loss and business reasons for the transaction would have to be carefully analyzed. It is for these reasons in large part that some have argued that, because of the imprecise facts, the Service's reliance in these rulings on the *Aiken* case is misplaced. Moreover, the analysis contained in the rulings further has to be considered in the context of other Service precedents bearing on the issue. These are considered below.

C. Other service precedents whose status is unclear

Since the Service did not specify whether other rulings bearing on treaty shopping structures should be considered to be modified, an examination of several of these will evidence other of the ambiguities created by the issuance of these two rulings.

In Revenue Ruling 75-118,[34] the Service ruled on the applicability of the 5% rate of dividends under the Dutch treaty. In that ruling, P, a Netherlands corporation, owned all of the stock of S1, a Netherlands corporation organized in 1947. S1 acts as a holding company with respect to the stock of three U.S. corporations (including S2, described hereinafter) and numerous foreign corporations. S1 acquired the stock of S2, a U.S. corporation in 1965 in a partial liquidation distribution from a Canadian subsidiary of P. The ruling states that "this liquidation was effected upon a belief that Canada might amend its income tax law in a way that the Canadian corporation would be taxed on dividends received from S2 and taxed on capital gain from a later disposition of the S2 stock."[35]

The facts further indicate that S1 has complete dominion and control over dividends which it received from S2 and was under no obligation to transfer such dividends to P.

Based on the foregoing and the fact that S2 otherwise satisfied the Dutch treaty requirements for the reduced 5% rate, the Service held that the Dutch treaty applied.

This ruling is of interest in the context of *Aiken* and Revenue Ruling 84-152 because of certain factors not specifically mentioned in the facts of the ruling, *viz.*, that a corollary consequence of the restructuring would, apart from foreign tax savings, also involve U.S. tax savings. Under the then Canadian-United States Income Tax Convention, as applicable to years subsequent to 1956, there was a 15% rate of U.S. tax on dividends. (Prior thereto, a 5% rate applied in certain circumstances.) Thus, perhaps another reason for the transaction involved U.S. tax savings; i.e. re-

28. 56 T.C. at 933.
29. 293 U.S. 465, 469 (1935).
30. Compare *Ross v. United States*, 251 F. Supp. 175 (S.D.N.Y. 1966), *aff'd* 368 F.2d 455 (2d Cir. 1966), holding that the tax payer's wholly-owned Bahamian corporation, which borrowed funds from third parties and relent the funds to its Liberian subsidiary, derived interest income. The taxpayer had argued that the Bahamian corporation was a mere conduit which exacted a small service charge for transmitting the loans and repayments to and from its subsidiary; however, the record showed no relationship between the payments aside from similarity of amount.
31. 56 T.C. at 934.
32. 56 T.C. at 933.
33. Compare Rev. Rul. 78-118, 1978-1 C.B. 219 with Rev. Rul. 72-514, 1972-2 C.B. 440.
34. 1975-1 C.B. 390.
35. 1975-1 C.B. at 391. See GCM 35904 (16 July 1974).

ducing the U.S. withholding tax to a 5% rate instead of a 15% rate. (The dividends presumably would not have been subject to taxation by S1 in the Netherlands because of its participation exemption.)

As noted, the Service does not discuss this potentially significant U.S. tax savings issue, but instead relies on the "dominion and control" factor.[36] Apparently, dominion and control exists even though a controlling shareholder can, through his voting power, cause a corporation to pay a dividend.

Though the facts of this ruling are "good" in view of S1's long and significant holding company status, and the presence of valid business (non-tax) reasons for restructuring, i.e. a foreign tax savings, it would appear that under the Revenue Ruling 84-152 approach, some doubt might be cast on the holding of the ruling.[37] Could Revenue Ruling 84-152 be extended to deny treaty benefits if a significant U.S. tax savings motivation exists, even if S1 retains dominion and control?

In Revenue Ruling 79-65,[38] the Service considered whether a dividend to be paid to an Antilles company would qualify for the 5% rate on dividends under the Antilles treaty in a situation where a third country national not entitled to treaty protection organized an Antilles company to own the stock of a U.S. corporation. The Antilles company did not provide the information to the Service to obtain the 5% rate on dividends under the Antilles treaty. Though the Antilles company declined to provide information that its relationship with the U.S. subsidiary was not arranged or maintained primarily with the intention of obtaining the 5% rate[39], the Service held the dividends would still qualify for the 15% rate on dividends.

Revenue Ruling 79-65 can be read as permitting treaty benefits to be obtained irrespective of the motivation for establishing the treaty-interposed structure[40] and might also be read to conflict with Revenue Ruling 84-152.

The importance of the factor of a major U.S. tax motivation in attempting to disregard a transaction without the presence of a conduit has to be confronted in rationalizing the two rulings discussed above with Revenue Ruling 84-152. In other words, does Revenue Ruling 84-152 and *Aiken* require both the presence of a major U.S. tax-avoidance purpose and lack of significant business purpose, as well as a conduit, or will either element suffice to support a Service treaty shopping assertion.

Whether treaty benefits can be denied on the basis that treaty benefits do not extend to entities that are organized in a treaty jurisdiction solely to secure the benefits of a treaty, which would otherwise be unavailable but for the interposition of the treaty protected entity has been considered. This type of approach has been used by the courts and the Service in certain above cases with the consequence that treaty benefits were not permitted to be claimed. For example, in *Johansson v. United States,*[41] the court denied the benefits of the Swiss treaty to a non-Swiss national who sought to come within its terms by establishing Swiss residence and creating a Swiss corporation through which he was employed. The purpose of this structure was to avoid U.S. taxation with respect to the purse of a prizefight occurring in the United States.[42] The court found that the treaty benefits should be denied because the entity utilized "had no legitimate business purpose, but was a device which was used by Ingemar Johansson as a controlled depository and conduit by which he attempted to divert, temporarily, his personal income earned in the United States so as to escape taxation thereon by the United States.[43]

This type of an approach may also derive indirect support from the *Aiken* case. There the Tax Court stated:

> In these circumstances, where the transfer of MPI's note [the U.S. Company] from ECI [the Bahamian company] to Industrial [the Honduran company] in exchange for the notes of Industrial left Industrial with the same inflow and outflow of funds, and where MPI, ECI and Industrial were all members of the same corporate family, we cannot find that this transaction had any valid economic or business purpose. Its only purpose was to obtain the benefits of the exemption established by the treaty for interest paid by United States corporation to a Honduran corporation. While such a tax-avoidance purpose motive is not inherently fatal to a transaction, see *Gregory v. Helvering,* supra, such a motive standing by itself is not a business purpose which is sufficient to support a transaction for tax purposes. (emphasis supplied)[44]

Commentators (even prior to Rev. Rul. 84-152) have noted that, for an *Aiken*-type challenge to be avoided, it is essential "to have a valid economic or business

36. This is one of the factors that the Service generally requires to be represented in private letter rulings requesting that dividends be subject to the 5% rate under the Dutch treaty. See e.g. PLR 8134143 (29 May 1981) and PLR 8134152 (29 May 1981); PLR 8503087 (25 October 1984).
37. In that regard, it should be noted that in GCM 35904, supra, and GCM 37865 (22 February 1979) the Service stated that the business purpose requirement of the "old" Dutch treaty (i.e. if the relationship of the two corporations had been arranged or is maintained primarily with the intention of securing such reduced rate) could not be incorporated into the "current" treaty for purposes of determining whether the favorable 5% rate applied to dividends. Under the current treaty as interpreted in the GCM's, if both the paying and receiving corporations are not "shams" (apparently referring to a transaction motivated exclusively by tax savings and which cannot be supported by non-tax factors), the 5% rate would apply, provided the other stated requirements were met.
38. 197-91 C.B. 458.
39. The information requested related to the business reasons for incorporating in the Antilles and whether dividends received from the U.S. subsidiary by the Antilles company would immediately be paid to its ultimate foreign investors.
40. See also Revenue Ruling75-23, 197-51 C.B. 290, discussed infra.
41. 336 F.2d 809 (5th Cir. 1969).
42. In that regard the court stated that: "Of course, the fact that Johansson was motivated in his actions by the desire to minimize his tax burdens can in no way be taken to deprive him of an exemption to which an applicable treaty entitles him. See *Gregory v. Helvering* (citation omitted) 336 F.2d 809 at 813.
43. 336 F.2d at 809. See also e.g. *Compagnie Financière de Suez et de l'Union Parisienne v. United States,* 492 F.2d 798 (Ct. Cl. 1974), *alt. holding* (even if the corporation involved were a French corporation, it would not qualify as a corporation for purposes of the French-U.S. tax treaty because none of its income was subject to tax in France); Rev. Rul. 74-331, 1974-2 C.B. 282 (U. K. corporation treated as agent of a non-treaty protected corporation).
44. '56 T.C., at 934.

purpose" and further "that there should be no direct or indirect link between incoming and outgoing payments."[45]

Aiken would appear to require more than merely a bad purpose.

Prior to the issuance of Revenue Ruling 84-152, the denial of treaty benefits solely for lack of a business purpose has been construed narrowly; the opportunity for profit or loss, and risk borne on the part of an interposed entity with respect to a particular transaction, as well as other than tax reasons, had been used to conclude that a sufficient basis existed to avoid characterization of the entity as a mere collection agent or conduit.[46]

Thus, even with the issuance of Revenue Ruling 84-152, it would appear that an attack based solely on a "bad" purpose should not generally be successful, since, if such had been the thinking of the Service, why would they have had to describe the conduit nature of the transaction? Moreover, authority exists which indirectly supports an argument for the availability of benefits to an interposed treaty protested entity regardless of the purposes underlying its creation. See *Robert K. Abraham,*[47] which involved a Netherlands Antilles corporation that acquired loans made by a Bahamian trust company to U.S. persons in connection with a U.S. tax shelter partnership. The Tax Court assumed that the notes evidencing such loan were transferred to the Netherlands Antilles corporation so as to obtain the benefit of the Antilles treaty's interest provisions, but it nevertheless found this to be a tax advantage given by law to a Netherlands Antilles corporation. The court stated, "If these tax advantages are 'loopholes', the problem is one for Congress and not the courts." Id., at 91.[48] Similarly, in Revenue Ruling 75-23,[49] the benefits of the Antilles treaty were extended to a Netherlands Antilles corporation which was organized to invest in real estate in the United States despite the fact that shareholders and noteholders of the corporation were non-residents of the Netherlands Antilles. So too, in *London Displays Co.,*[50] and in Revenue Ruling 79-65, supra, the benefits of the Antilles treaty were allowed to a corporation established by a non-Antillean person solely for the purpose of collecting United States source royalties and dividends, respectively. It is significant, however, that the three aforementioned precedents did not involve back to back transactions.

Finally, the Service has in certain instances not applied a conduit approach. In Revenue Ruling 80-362,[51] the Service considered a transaction wherein a third country national, not a beneficiary of a bilateral income tax convention with the United States, licensed for a fixed royalty annually the U.S. rights to a patent to a Netherlands corporation which is stated to be a bona fide corporation unrelated to the licensor. The Netherlands corporation, in turn, relicensed the right to use the patent to a U.S. corporation for use in the United States on terms which are based on the number of units produced by the United States licensee under the patent. The ruling holds that amounts paid to the Netherlands corporation are exempt from U.S. taxation under the Dutch treaty, but that amounts paid by the Netherlands corporation to the third country national are U.S. source income, based on section 861(a)(4) which provides that royalties paid in consideration for the privilege of using a patent in the United States are treated as income from U.S. sources, irrespective of the fact that the payer is a foreign corporation.

In this ruling, the Service did not treat the Netherlands corporation as a conduit; in fact, no reference is made as to whether the Netherlands corporation made a profit, though the amount of consideration paid to the third country national may be different from the consideration received by the Netherlands corporation in that in the former case the consideration is fixed while in the latter it is contingent.

Thus, the Service apparently views certain back to back transactions acceptable provided (1) the parties are unrelated and (2) the terms are different.

III. CONCLUSION

In summary, the two rulings can be interpreted to extend the holding of *Aiken,* which involved a back to back transaction with essentially identical terms, to apply to the common situation of an interposed treaty-protected entity in a back to back situation, with a nominal business purpose and a profit element. The rulings have a potentially extremely broad application in that under their respective facts the Service stated that the interposed treaty protected Antilles corpora-

45. See Vogel, Berstein and Nitsche, *Inward Investment in Securities and Direct Operations Through the British Virgin Islands: How Serious a Rival to the Netherlands Antilles Island Paradise,* 34 Tax L. Rev. 321 at 331 (1979). Cf. *IIT v. Vencap, Ltd.,* 411 F. Supp. 1094 (S.D.N.Y. 1975), where in a non-tax context, the court held that a loan from a foreign corporation to a U.S. person, which had been channeled for U.S. income tax purposes through a foreign bank (for a 1.5% fee) and through a Netherlands Antilles corporation (at a 1% spread), was a direct loan from the foreign corporation "despite its circuitous route." Id. at 1100. The court found significant the fact that the risk of loss remained with the foreign corporation which was the original source of the funds.

46. As discussed above, in *Aiken* the court examined the purpose for the particular transaction and did not permit the form of the transaction to control on the basis of the fact that the Honduran entity was a "bona fide" entity. See also *Photocircuits Corp.,* supra, (statement by the Court that mere recognition of a corporation's separate existence is not enough to verify its role in a particular transaction.)

47. 33 TCM 81 (1974).

48. In the context of the Antilles treaty, the Statement of the Treasury Department with Respect to the Protocol Dated 23 October 1963, Amending the United States – Netherlands Antilles Tax Convention, 1965-1 C.B. 667, provides that "the Treasury continues to recognize the desirability of encouraging foreign portfolio investment in the United States", and further provides that "[exemptions from] and reductions in U.S. tax on United States source income paid to non-resident-owned Antillean investment and holding companies are not justified as long as this income is taxed at low rates (not exceeding 3% at present) in the Netherlands Antilles" [emphasis added]. This understanding may be helpful in analyzing situations under the Antilles treaty and does not necessarily apply in other treaty contexts.

49. 1975-1 C.B. 290.

50. 46 T.C. 511 (1966), acq. 1967-1 C.B. 2.

51. 1980-2 C.B. 208.

tion is a valid corporation, not thinly capitalized and thus the arguments of sham transaction or thin capitalization, respectively, are not applicable; rather, the Service focuses on the conduit nature of the transaction by indicating that for the interposed treaty recipient to obtain the benefits of the Antilles treaty, it is necessary that such recipient have sufficient dominion and control over the funds received with respect to which the treaty benefits are claimed so as to be considered the beneficial owner of such funds.

Thus, assuming *arguendo* the validity of the two rulings, their exact scope remains somewhat unclear. Certain knowledgeable tax practitioners have expressed the view that they believe the Service has exceeded its authority with the issuance of these two rulings. This matter will ultimately be resolved by the courts, because, as indicated above, a ruling is merely an interpretation by the Service of the application of the Internal Revenue Code to stated facts.

However, irrespective of that outcome, it has to be emphasized that the U.S. attitude towards treaty shopping continues to be rather tough. The attitude of the Treasury Department (to include the Service), is reinforced by that of Congress,[52] which is also concerned with treaty shopping. Thus, any treaty shopping planning has to be viewed in the context of the current climate, with the expectation that closer audit scrutiny will be given to any such transaction, and that efforts will continue to limit benefits of treaties to third country nationals.

52. This can be evidenced by several recent developments. Section 342 of the Tax Equity and Fiscal Responsibility Act ("TEFRA") instructed the Service to review and revise, if it thought appropriate, the procedural mechanisms for treaty recipients to obtain rate reductions with respect to fixed or determinable income. Under current regulations, a U.S. withholding agent may apply a reduced treaty rate with respect to dividends merely by reference to the foreign address of the recipient. With respect to other payments, such as interest or royalties, the recipient merely has to file a Form 1001 certifying that he is a qualified recipient. Under the proposed regulations recently issued by the Service under section 1441 pursuant to Section 342 of TEFRA, such self-certification procedures are amended to provide that, in case of all payments of fixed or determinable income, the treaty recipient must obtain a certificate of residence from the local tax authority and submit such certificate, together with a Form 1001 signed under penalties of perjury (and any other item such as a revenue ruling required by a particular treaty) to the U.S. withholding agent for the withholding agent to withhold at the reduced rate. Absent factual knowledge of the withholding agent to the contrary, the withholding agent may rely on the material submitted. However, if this procedure is not complied with, withholding at the source is required at a 30% rate, with the opportunity for the treaty recipient to file a claim for refund. The withholding agent is required to forward the certificate of residence to the Service on Form 1042, describing payments made by such withholding agent to foreign persons. By reference to recent public statements made by the Service, it is likely that the Service will computerize such statements in an effort to audit them in a more complete manner.

The issue of treaty abuse also has to be considered by reference to Congressional action as reflected in two recent pieces of legislation. First, the Caribbean Basin Initiative ("CBI") legislation. The tax portion of this legislation permits a deduction to be claimed for convention expenses held in certain designated countries, provided such countries enter into a satisfactory exchange of information agreement with the United States, which agreement permits the exchange of both civil and criminal information, as defined under U.S. law, relating not only to local residents, U.S. persons, but also to third country nationals, and which agreement supersedes financial secrecy laws of the particular jurisdiction. Second, this exchange of information standard has also been incorporated in the recent foreign sales corporation legislation by reference to permitting only those foreign jurisdictions which otherwise have a satisfactory exchange of information agreement by reference to the standards of the CBI legislation, or by reference to a determination made by the Secretary of the Treasury, to be the situs for incorporation or of an office of a foreign sales corporation, see also footnote 14. See also e.g. section 651 of H.R. 3838, 99th Cong., 1st Sess. (1985) which contains a treaty-override provision with respect to the imposition of a branch-level tax in certain treaty-shopping situations. This is further explained in H.R. Rep. 99-426, 99th Cong., 1st Sess. 435 (1985).

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II. REPORTS AND DOCUMENTS

III. IFA NEWS

IV. CONFERENCE DIARY 22,60,137

V. BIBLIOGRAPHY 36,87,138

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Contents

of the June 1986 issue

INDIA:
Long-term Fiscal Policy – A Critique

By G. Thimmaiah

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I. BACKGROUND

The Long-term Fiscal Policy (LTFP), announced by the Government of India in December 1985, has received a lot of publicity as though it is something original and undreamt of in the fiscal history of modern democracies. We all know that the very concept of fiscal policy emerged in the academic, as well as official circles, only after the great depression. The economic foundations provided by Keynes' General Theory justified the use of fiscal policy for managing the short-term economic situations. Since fiscal policy had to be implemented through annual Budgets, the budgetary policy had to change sometimes every year depending upon the economic situation obtaining in the country concerned. In other words, the very purpose of fiscal policy was to manage annual fluctuations in the economic activities of the capitalist countries and therefore, it was conceived as a short-run discretionary policy.

However, when fiscal policy came to be used for the purpose of mobilizing resources and for providing public sector support for developmental activities in the developing countries, fiscal policy came to be conceived in terms of long-term perspective as well. This led to a great deal of modification, reformulation and re-assessment of the tools as well as the effects of fiscal policy which were recommended to be used for promoting development with equity in the developing countries. There was also an attempt in the Western World to conceive long-term fiscal policy at least in the form of a long-term expenditure programme. This was done in England on the recommendation of the Plowdon Committee. The Plowdon Committee recommended in 1961 that public expenditure be planned over a 5-year timespan in relation to the growth of real resources. The Labour Government in the United Kingdom started publishing a national plan in which the public expenditure was allowed to increase faster than real resources. Such a long-term plan gave some idea about the Government's plan of future expenditure. But after some time such a long-term policy of Government lost its usefulness and hence its glamour. But such innovations were not publicized as much as the recent LTFP has been publicized. What is more, the LTFP is conceived and used as a sort of philosophical foundation for justifying certain controversial fiscal measures which were introduced during 1985-86 such as reduction of rates of direct taxes, enhancement of investment limits for MRTP (Monopolies and Restrictive Trade Practices) companies and the so-called "rationalization of indirect tax rates" on non-essential commodities. Against this background, let us examine the claims and contents of LTFP.

The LTFP aims at achieving stability of tax rates and incentives and to do away with secrecy relating to tax policy. While "stability" (or continuity) is very important from the point of view of enabling the private sector to make long-term economic decisions particularly relating to investment, it is not sufficient to stimulate private investment. A major determinant of private investment has come to be acknowledged as the level of public sector investment, particularly the plan outlay. Therefore, the LTFP's premise of encouraging private investment through stability of tax rates and allowances is not altogether convincing. No doubt, unnecessary secrecy is wasteful, but in matters relating to Budget proposals some degree of secrecy cannot be avoided. This obvious fact is played down by the LTFP.

The LTFP believes that some sort of rule-based fiscal policy or built-in, automatic fiscal responses should be used to manage a complex Indian economy. But continuous vigilance over the economic trends and appropriate discretionary policy measures cannot be avoided in the short as well as in the long-run to manage the complex as well as fragmented Indian economy. Long-term policy may provide a broad framework within which detailed decisions will have to be made on an annual basis, but that broad framework may have to be changed periodically in response to changing requirements which may force themselves on the reluctant and perhaps, obstinate policy makers in India.

II. LONG-TERM TAX POLICY

The decision to retain the gift tax is a wise decision. The Union Budget for 1985-86 relegated equity objectives of taxation to secondary importance. This generated severe public criticism. The criticism seems to have been well taken by the Finance Minister, as is evident by the decision to retain gift tax. Gift tax was imposed to prevent evasion of both estate duty and wealth tax. The abolition of the estate duty in 1985 was a wrong decision. The justification was not convincing. Gift tax is necessary to prevent evasion of wealth tax. In addition to gift tax, it is also necessary as a long-term measure to bring back an alternative to estate duty in the form of an assets transfer tax.

It may be mentioned here that, under Article 269 of the Indian Constitution, the Central government is supposed to levy an inheritance tax for the benefit of State governments. When the Central government remained indifferent, the matter was forced to be referred to the Fifth Finance Commission. The Commission felt that since estate duty and inheritance tax were similar in nature, there was no need to levy an inheritance tax when estate duty was operating. Now the estate duty is abolished and therefore it is necessary to levy some form of an inheritance tax not only for the benefit of State governments, but also for achieving equity in ownership of wealth. Hence, an assets transfer tax is in order.

Constitutionally, the Central government cannot levy agricultural income tax. If it ever attempts, it will further worsen the relations between the Central and the State governments. The scheme to float public sector bonds is only intended to tap rural savings, but it cannot be a substitute for tax on rural incomes. It is better to persuade the State governments to transfer the power to levy agricultural income tax to the Central government and then to transfer the net yield back to the State governments. Such a proposal will no doubt face opposition by the State governments, but they may be persuaded if the Central government discontinues the presently operating additional Union excise duties.

Value Added Tax (VAT) is a modern method of levying indirect tax. Modernization of the economy should go along with the modernization of "tax handles". The policy of moving gradually towards VAT is a welcome measure. The Government is also aware of the revenue implications of the introduction and possible extension of MODVAT (Modified Value Added Tax). Even higher rates of tax on the final product will push up the prices less than the same rate of tax, spread-over inputs and final product, because of the absence of a "cascading" effect. But is is necessary to recognize the two weaknesses of MODVAT. The yield from MODVAT will be lower (i) in the initial years, till the administration gets used to the procedures; and, (ii) when the performance of the industrial sector becomes unimpressive. Besides, it will not be possible to achieve as many and varied objectives of Government under MODVAT as has been attempted under the present systems of excise duties. Further, the benefit of reduced tax burden may not be passed on to the consumers.

The restructuring of customs duties was long overdue. This is consistent with rationalization of excise duty structure. These rationalizations will not only reduce paper work, but will also promote modernization of industrial equipment. Simplification of duty drawback might encourage exports subject to competitiveness of the prices and quality of the products.

The National Deposit Scheme is an attempt to gradually transform the individual income tax, which is already a partial expenditure tax, into a full fledged expenditure tax in the course of time. An interest of 10% on the deposits under this scheme is reasonable and if we include tax amount saved, the true interest will be much higher. But it is doubtful whether the National Deposit Scheme will unearth substantial black money as the behaviour of black money is determined by several other factors.

The gradual replacement of the present income tax by a comprehensive expenditure tax will reduce revenue, particularly to the State governments. And in the absence of estate duty and steeply progressive wealth tax, expenditure tax will not enable the Government to achieve the objective of reducing economic inequalities. Therefore, the aim should be to retain the present income tax and in addition, to levy progressive expenditure tax above the income slab of Rs. 100,000. This was the purport of Kaldor's original proposal.

In regard to the corporate tax structure, the LTFP has tried to hand out some more, though minor, concessions. The decision to abolish the surcharge and surtax as of 1987-88 was unnecessary when the tax rate was already reduced. There was no justification for promising further reduction of corporate tax rates in the Budget for 1986-87 and, fortunately, that promise has been dropped in the LTFP, and, furthermore, the decision to continue a surtax for one more year is wise. Further, the decision to discontinue the investment allowance from 1987-88 is a welcome measure as it has been misused quite apart from benefiting big companies, but the deletion of Section 80 VVA (limiting the benefit of certain deductions) is not a wise decision as the Government could have waited for some time to observe the compliance (or lack thereof) of the corporate sector in regard to the 20% tax deductible deposit with the IDBI (Industrial Development Bank of India).

As we have already noted, the corporate investment behaviour is determined by a host of other factors in addition to tax rates and other incentives. The LTFP is still trying to pamper the private corporate sector without realizing that the private corporate sector's contribution to domestic savings is less than 2% and the employment generation is totally unimpressive. The main motive of the private corporate sector in India is to make a "quick buck" which is not going to make India an industrialized country let alone take it into the 21st century. As compared to the private corporate sector, individual income earners deserve some reduction of tax rates at the initial two slabs.

There is also some contradiction in the inherent philosophy of the LTFP. On the one hand, the LTFP stresses the need for mobilizing additional resources for meeting massive outlay contemplated in the Seventh Plan, particularly for an anti-poverty programme. But, on the other hand, the Government is again giving tax concessions to undeserving sections of the society. This contradiction cannot be resolved by making reference to a possible increase in tax revenue as a result of lowering tax rates. The evidence to this effect is not convincing, not only from Indian experience, but also from the experience of the U.S.A. which pinned too much faith in supply side economics. Therefore, it is necessary to be cautious in this sphere.

III. LONG-TERM EXPENDITURE POLICY

The LTFP appears to be a misnomer as it contains mainly long-term tax policy guidelines. There is nothing much about the long-term expenditure policy guidelines except some sermons on expenditure on interest payments and subsidies. The long-term framework of public expenditure indicated in the Seventh Five Year Plan is not adequate or even relevant for non-plan expenditure.

The LTFP has very clearly juxtaposed the expenditure on subsidies and deficit financing. it is argued that deficit financing is forced on the Central government by the inevitable expenditures on subsidies. In other words, the people are asked to choose between deficit financing and expenditures on subsidies. Supposing the Central government reduces subsidies, particularly on fertilizers and foodgrains, then we will be discouraging foodgrain production and exposing the urban consumers to the vagaries of the market forces, particularly the black market operation. The hardships which may have to be faced by the poor and the middle class on account of the scarcity of foodgrains as a result of reduced foodgrain production and the consequent increase in foodgrain prices in the urban areas, will be more than the hardships caused by the inflationary situation originating from deficit financing. The LTFP seems to believe that the reverse is true. It is this line of thinking that we have to challenge. Further, it is true that the subsidies create some distortions in the relative prices. But the very nature of the operation of budgetary measures is such that they do create distortions in any field, including taxation and expenditure. And, therefore, it is very difficult to accept the argument that only subsidies create distortions and other fiscal tools do not. What is important is whether any useful purpose is served by providing subsidies. It may be noted here that the non-plan expenditure on subsidies has come down marginally from the revised estimates for 1985-86 by Rs. 2,800,000,000 in the Budget estimates for 1986-87. The amount of subsidy envisaged in 1985-86 Budget estimates was Rs. 39,590,000,000. This was revised upwards to Rs. 49,210,000,000 in the revised estimates for 1985-86. But in the Budget estimates for 1986-87 the total amount of subsidy has come down to Rs. 47,410,000,000. This reduction has been effected as a result of reduced subsidy for indigenous production of fertilizers, discontinuation of subsidy for sugar, keeping export subsidy constant and so on. However, the subsidy on food and imported fertilizers has increased. Furthermore, it is surprising that a provision for Rs. 1,470,000,000 of subsidy is made for the railways during 1986-87 when the railway Budget has produced a surplus. Therefore, all attempts should be made to reduce unjustifiable subsidies, but at the same time we have to make sure that the subsidies do serve some broad social objectives. If we are sure about this, then we should not hesitate to go in for deficit financing. However, we should resort to deficit financing only when we cannot raise resources from the traditional sources like taxes and non-tax current revenue for providing subsidies. The present Government has decided to reduce the tax burden in the country by lowering marginal rates of almost all direct taxes and rationalizing the rates of indirect taxes. The inflationary impact of rationalizing the rates of indirect taxes is welcome, but giving up revenue by frequent reductions in direct tax rates is an unwise decision, because it amounts to choosing between raising revenue from direct taxes and deficit financing for subsidies – a choice between equity and inequity. Therefore, instead of raising funds through taxation and by forcing the public enterprises, other than ONGC, to produce surpluses, the Central government is trying to justify deficit financing to continue subsidies. Subsidies are inevitable in the Indian socio-economic context, therefore, the Central government will have to stop foregoing tax revenue and use tax and non-loan non-tax revenues to meet the expenditure on subsidies.

The interest burden on the Government debt has started showing up in the recent past. Public borrowing was managed by the Reserve Bank of India and the Finance Ministry in such a way as to keep the interest burden on market borrowings to the minimum, but because of the overall upward movement of the cost-price structure, the Government was forced to increase the interest rates on developmental loans and, consequently, the expenditure on account of payment of interest has gone on increasing. If this trend continues for a long time, a major portion of the non-plan expenditure will have to be devoted to interest payments. In this context, the Chakravarthy Committee has recommended that the public should be encouraged to subscribe to Government loans by offering attractive rates of interest. If this recommendation is accepted and implemented, the interest payment on borrowings will be enormous. The Committee has countered such a consequence on the ground that if the public subscribes substantially to the Central government loans, to that extent the Reserve Bank of India's net credit/lending to the Central government will come down. This will have a contractionary effect on the money supply and on the price level. Such a decline in the price level will enable the Central and State governments to save on the expenditure side. The consequent savings on expenditure will offset the rise in expenditures on account of the increased interest burden on public borrowing. This line of thinking will remain only as an academic exercise far removed from practical reality. Therefore, the Central government will have to take some practicable policy decisions to keep the interest burden on market borrowings at a reasonable level. Unless we are sure of a direct monetary return on the investments undertaken with such borrowed money, it would be foolhardly to borrow at higher interest rates from the public and invest in socio-economic infrastructure projects like roads, bridges, buildings and even irrigation projects, which do not yield any direct monetary return. Therefore, we have to make a distinction between financially remunerative as well as socially productive and financially unremunerative though economically and socially productive projects. The Government may borrow at a higher rate of interest and invest in the first category of projects. However, for the second category of projects, the borrowings should be confined to Government controlled financial institutions which may be made to lend at predetermined lower rates.

IV. LONG-TERM PRICE POLICY

The LTFP has not outlined any guidelines for maintaining price stability during the Seventh Plan period. References to price stability are only contextual, particularly in the context of the Government's rationalizing of the indirect tax rates to minimize the cascading effect and in the context of the need to reduce subsidy and deficit financing. This is another important component of fiscal policy which is missing in the LTFP.

The Government Budget creates price instability through three main fiscal mechanisms. First, when the Government expenditure goes on increasing, particularly on the non-development side, it adds to effective demand. Given the level of output and sectoral rigidities, such a progressively increasing public expenditure will add to price instability through the demand-push mechanism. Secondly, frequent hikes in the rates of indirect taxes, particularly union excise duties and sales tax, create a cascading effect and thereby push up the price level. Thirdly, the attempt to cover the Budget deficit by resorting to deficit financing, in particular by resorting to short-term borrowing from the Reserve Bank of India, increases the money supply and ultimately the price level through the mechanism of the classical quantity theory of money. These are the three direct sources of price instability originating from the Government Budget. There are a host of other indirect processes whose direction and effect cannot be clearly identified.

The LTFP has no doubt indicated the Government's readiness to reduce non-plan expenditure like interest payments and subsidies, but there are no indications of specific ways through which the Government is planning to achieve such a reduction. Besides, the Government has started rationalizing the rate structure of indirect taxes and, in the Budget for 1986-87, MODVAT has been introduced as a first step in this direction. The moderating effect of MODVAT on price levels will not be immediately felt, but it is a step in the right direction which will reduce, though not eliminate, the cascading price impact of indirect taxes.

But the LTFP has not indicated any guideline relating to the level of Budget deficit and the use of deficit financing to cover the deficit Budget. The LTFP only tries to relate the deficit financing to growing subsidies. In other words, the Central government's decision regarding the use of deficit financing to cover overall Budget deficit is not clearly stated. It may be mentioned in this context that the Chakravarthy Committee has recommended that the price impact of deficit financing should be estimated, taking into account both short-term borrowing through ad hoc Treasury Bills and also through borrowings from the Reserve Bank of India for the purpose of filling the gap in market borrowing left by the commercial banks and the Life Insurance Corporation. The Chakravarthy Committee has very clearly indicated that the total borrowings from the Reserve Bank of India should be decided after estimating the probable rate of growth of GDP, tolerable limits of inflation and the income elasticity of demand for money supply. Though these indicators are very helpful, the way they are linked by the Committee gives an impression that the Central government is advised to achieve price stability by first deciding the tolerable rate of inflation. This is circular reasoning. The Central government should decide first about the planned rate of growth of GDP, particularly foodgrains output. Then, after taking into account the income elasticity to demand for money, the Central government should be able to determine the rate of growth of the money supply which will ultimately determine the price level. The Finance Minister has indicated in the Budget for 1986-87 that the Government of India has accepted the recommendations of the Chakravarthy Committee in regard to the extent of deficit financing, but the details are not spelt out. We have to wait and see how the Central government is going to translate the recommendations of the Chakravarthy Committee into practice.

V. OTHER POLICIES

The LTFP has made references to some other related policy issues. They include: the measures to increase the savings rate in the country, particularly the policy of increasing surpluses from public enterprises with a view to increasing public sector savings; simplifying tax laws; stringent measures for discouraging tax evasion; and providing other incentives for the corporate sector, etc.

A separate chapter is devoted for indicating the extent of public sector savings which will have to be generated over the Seventh Five Year Plan period for financing the plan outlay, but no specific measures are outlined. In the case of private savings, some new schemes like the National Deposit Scheme have been announced. It is decided to create a Venture Capital Fund with a paid-up capital of Rs. 100,000,000 to encourage adoption of indigenous technology by Indian industry. Certain measures to prevent tax evasion and smuggling activities are listed. But all these do not add up to long-term policy guidelines as many of these measures were already indicated or announced on earlier occasions and, if not, could have been announced in the annual Budget. In other words, the varied contents of the so-called LTFP prove our earlier contention that it is more an attempt to justify the controversial tax measures which were announced in the 1985-86 Budget, than a policy statement outlining any meaningful long-term guidelines for formulating the comprehensive fiscal policy of this country.

Long-Term Fiscal Policy 1985

Its Bearing on Direct Taxes in India

By Parimal M. Parikh

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The long-term fiscal policy (LTFP), announced by the Finance Minister of India in December 1985, carried forward his desire to "lift the veil of secrecy" from Budget making and to take the people into confidence regarding likely policy decisions. The annual Budget exercise will no longer seem like pandora's box opening, with people anxious to know what is in store for them.

Enunciation of a long-term fiscal policy assures a degree of certainty in some spheres and makes planning more purposeful both in the public and the private sectors. The LTFP, in short, broadly indicates the nature of the next four Budgets. Like all fiscal policies, the LTFP deals with taxation and expenditure, laying greater stress on taxation.

The LTFP's pronouncements on direct taxes are:

INCOME TAX

A. Rates of personal income tax

The Finance Act 1985 reduced the personal rates of income tax. The LTFP ensures stability of the tax structure by stating that the personal income and wealth tax would remain unchanged for a minimum period of five years, excepting compelling circumstances whereby a surcharge on income tax would be introduced as a temporary measure. The LTFP recognizes that inflation progressively increases the effective rate of taxation for given levels of real income and wealth through the process of "bracket creep" and, consequently, states that adjustments will be made in tax brackets considering the impact of inflation, the overall budgetary position and other relevant factors.

B. Simplification of direct tax laws

The Government has decided to rewrite the direct tax laws with the following, among other objectives, in view:

- to rationalize and simplify the laws in order to make the provisions easier to administer;
- to improve the effectiveness of the provisions for curbing tax evasion;
- to build effective deterrent penal provisions;
- to bring about uniformity of procedures for all direct taxes; and
- to reduce the categories of taxable entities.

The Draft Bill incorporating the necessary amendments is expected to be ready by June 1986.

C. Incentives for saving

The Government has recognized the importance of savings for maintaining the momentum for growth of the economy. It feels that the present incentives for saving, which are subject to limits, are insufficient. It has therefore been proposed to introduce a new investment instrument which would qualify for deduction from personal income, without any overall ceiling, to the extent of 50% of such investment. This instrument is proposed to be designated as National Deposit Scheme (New Series) and would be in the form of a Deposit Account to be maintained by designated banks. The net addition/deduction to the account would be allowed as a deduction or added back in case there is a fall in the balance in the respective year. The proposal has been kept open to public opinion before a final decision is made.

D. Corporate tax reform

The Finance Act 1985 had reduced the corporate tax by five percentage points and posed two alternatives; viz., a further reduction in taxes by five percentage points in the next year and withdrawal of surcharge and surtax in the third year as well as withdrawal of investment allowance in a phased manner or retention of the investment allowance with no further cut in rates.

The LTFP indicates Government's favour towards withdrawal of investment allowance, due to the various drawbacks of investment allowance (IA) such as:

(1) IA favours the large and more well-established enterprises, because investment allowance in respect of new units can be set off against profits of old established units without earning profits from fresh investment.
(2) It is available to those who save out of profits and invest, as well as to those who can command capital funds in general, thereby showing favour for the established industrial sector.
(3) Since IA is related to the cost of plant and machinery irrespective of how it is financed, it leads to profit distortion, depending on the extent of external finance or internal resources used.

IA is proposed to be replaced by a scheme whereby corporate enterprises would be allowed to deduct a specific fraction of their profit from taxable income if deposited with the Industrial Development Bank of India and other notified institutions, which would earn interest @ 10% per annum. To avoid hardship to companies not able to generate sufficient profits early, repayment of borrowings made for investment in specified purposes by drawing on profits so funded are also proposed to be treated as approved purposes. Also, investment in new plant and machinery made directly out of profits of the year will be regarded as "funding" for purposes of the deduction contemplated in this scheme. This deduction is to be restricted to 20% of the profits that would be otherwise taxable. The deposit would have to be made within six months from the end of the relevant accounting year.

The Government proposes to review the other tax concessions and withdraw as many of them as feasible. Once IA is withdrawn "the zero tax company" provision section 80VVA[1] of the Income-tax Act 1961 will also be removed. The rates of depreciation on assets used for business are to be simplified by having just two or three categories of rates.

E. Capital gains taxation

The LTFP proposes to exempt from capital gains tax all appreciation prior to 1 April 1974. Secondly, there will only be two rates for deduction of long-term capital gains;[2] viz., 50% for gains from real estate and 60% for other assets. Further investment in bonds of public sector corporations out of the sale proceeds of capital assets sold, would also exempt the same from capital gains tax.

F. Measures against tax evasion

Sticking to its earlier stand of not harassing the honest taxpayer and at the same time punishing the tax evader, a series of measures are proposed.

These are:

(1) accepting income returns of non-corporate assessees showing returned income of less than Rs. 100,000 subject, however, to a thorough scrutiny of a specified random sample of the accepted returns;
(2) shifting the onus of proving the evasion of income from the income tax department to the taxpayer;
(3) ensuring effective follow-up of search and seizure operations;
(4) ensuring speedy trial of cases of tax evasion by establishing special courts;
(5) evolving a system of rewards and punishments to promote integrity among senior tax officials; and
(6) modernizing the administration of direct tax with the aid of computers.

In addition, all persons, previously assessed or not, have been given an opportunity to declare true income/wealth without attracting penalty/prosecution if done before 31 March 1986.

To force disclosure of the unaccounted portions of transactions in real estate, LTFP proposes to confer on the Government a pre-emptive right to acquire property undergoing transfer at a value of 15% above the price or consideration stated in the transfer deed. Initially only properties in metropolitan cities and worth more than Rs. 1 million are proposed to be covered. To simplify matters, the Government's pre-emptive right will remain in force for only sixty days after the seller applies for the clearance certificate from the income tax department.

G. Wealth and gift tax

No changes of any consequence are proposed in the wealth tax structure, excepting that the valuation rules with regard to certain assets are proposed to be simplified and rationalized.

The Gift-tax Act 1958 has lost much of its importance due to the abolition of estate duty (death duty). As a consequence of this, there is no motive for a living person to transfer wealth/income to family members. However, to avoid any undue diversion of income/wealth, the Government proposes to continue the gift tax by raising the exemption limit, which was fixed many years ago, to compensate for the increase in prices.

H. Taxation of non-residents

The changes proposed above are all in relation to taxation of residents. As for the non-residents, the concessional rate of tax on income from specified investments would continue. A status quo has been maintained.

All said and done, the policy admits the need of stability in the fiscal future of India. There will no longer be a shroud of secrecy while formulating Budget proposals. At the same time, one cannot help feeling that the LTFP ignores the truth that between the two objectives of raising resources and stimulating growth, the latter is more important. Increased governmental resources would be the inevitable result of growth, whereas growth has never been the result of increased resources. But none can deny that the approach of the Finance Minister is bold and pragmatic. This, coupled with the desire to simplify laws and make it possible for honest taxpayers to save their income, will go a long way in strengthening the foundation of India's economy.

1. Section 80VVA provides that companies which are entitled to certain deductions shall use the same subject to a maximum of 70% of their taxable income, i.e. the minimum income liable to tax would be at least 30% of their taxable income before the application of the deductions, thus *preventing* these companies from becoming "zero tax companies".
2. Currently, the computation of long-term capital gains is rather complex. Under the new provisions 50% of the long-term gains derived from real estate and 60% of long-term gains derived from other assets will be taxable.

The Argentine Income Tax Reform

By Pedro Massone*

CONTENTS

I. INTRODUCTION

A. The Argentine tax reform of 1985

In October 1985 Argentina published several laws introducing various amendments to direct and indirect taxation. The new legislation changes certain taxes and includes the following acts:

- Law 23,243 published in the Official Bulletin of 14 October 1985 amending the tax on interest (impuesto sobre los intereses y ajustes de depósitos a plazo), in order to exempt interest and indexation derived from deposits with fixed terms equal to or exceeding 120 days.
- Law 23,256 published in the Official Bulletin of 2 October 1985 introducing a temporary and compulsory saving, computed in connection with the taxpayer's saving capacity.
- Law 23,257 published in the Official Bulletin of 10 October 1985 introducing amendments to the tax on the transfer of shares (Impuesto sobre la Transferencia de Títulos Valores), that include an increase of the tax rate from 0.5% to 0.75%.
- Law 23,258 published in the Official Bulletin of 14 October 1985 introducing amendments to the stamp tax law (Impuesto de Sellos) of the Federal Capital (federal district of the City of Buenos Aires).
- Law 23,259 published in the Official Bulletin of 11 October 1985 introducing a new capital gains tax law (Ley de Impuesto sobre los Beneficios Eventuales), the coverage of which is now limited to individuals and undivided inheritances.
- Law 23,260 published in the Official Bulletin of 11 October 1985 introducing amendments to the income tax law (Ley de Impuesto a las Ganancias), that extend the duration of the tax up to 31 December 1995 and include a number of changes which are discussed in this article and are the principal scope thereof.
- Law 23,271 published in the Official Bulletin of 21 October 1985 providing that the tax administration, when carrying out its duties, will not be limited by any provisions concerning the bank and stock market secrecy.
- Law 23,285 published in the Official Bulletin of 30 October 1985, that extends the duration of the Net Worth Tax (Impuesto sobre los Capitales) and Net Wealth Tax (Impuesto sobre el Patrimonio Neto) up to 31 December 1985.
- Law 23,296 published in the Official Bulletin of 30 October 1985, introducing amendments to the net worth tax (Impuesto sobre los Capitales), that include changes concerning reduction of exemptions, valuation of assets and liabilities.
- Law 23,297 published in the Official Bulletin of 31 October 1985 introducing amendments to the net wealth tax law (Ley de Impuesto sobre el Patrimonio Neto), that include changes concerning reduction of exemptions, valuation of assets, tax rates (with an increase of the marginal rate from 1.5% to 2%) and taxation of non-residents.

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The most important developments are the amendments to income taxation and they shall be subject of this article. We will not refer, however, to the income tax law in its entirety; the article instead shall focus on the principal features of the income tax and especially on those areas where important changes have been introduced or which have special interest for enterprises, investors and non-residents.

B. Historical information on the income tax

The Income Tax Law was first established in Argentina in 1932, under a typical schedular scheme. Since that time the tax has been amended in order to make the system global with regard to all income from Argentine sources, as well as for other purposes. Nevertheless Income Categories have not been abolished.

The current Income Tax Law has been in force since 1 January 1974. Since the National Constitution only allows the government to levy the direct taxes for limited periods of time, the power of the National Government to tax income was not permanently granted. Like the former income tax in force until December 1973, this income tax had a 10-year duration, at the end of which a new enactment would have been necessary to extend the tax another 10 years. However, Law 22,902 of 8 September 1983 extended the duration of the income tax up to 31 December 1985.

The tax reform of 1985 (namely Law 23,260 published in the Official Bulletin of 11 October 1985) amends the income tax and further extends its duration up to 31 December 1995.

C. Principal income tax changes

Some of the most important income tax changes are briefly referred to, as follows:

(i) under the old law the income of limited liability companies was taxed both in the hands of the company and in the hands of partners and now is taxed in the hands of partners only;

(ii) recipients of Third Category income could use either the cash or the accrual method but, after the reform, shall compulsorily use the accrual method;

(iii) new valuation rules are introduced as regards inventory, real property in trade and agriculture related assets;

(iv) deduction rules concerning interest, salaries, entertainment expenses, directors' fees, profit distributions, depreciation of buildings and losses are amended;

(v) the taxation of dividends undergoes several changes, e.g. dividends in general that were exempt in the case of resident shareholders who identified themselves upon collection of the dividends are now taxable when the dividends are paid to individuals, but a credit is granted to the recipient;

(vi) the tax rate applicable to dividends paid to non-residents is increased when paid to non-residents who do not identify themselves upon collection of the dividend;

(vii) although the tax rate applicable to income derived by non-residents (other than dividends) is not changed, the percentages used to arrive at taxable presumptive net income have been amended, resulting in an alteration of the effective rate;

(viii) the taxation of capital gains is changed especially as regards the special capital gains tax for which a new law is enacted and the coverage of the special tax is limited to individuals and undivided inheritances only;

(ix) several changes are introduced to the adjustment of income for inflation, e.g. to cover adjustments corresponding to changes in assets and liabilities incurred during the taxable period; and

(x) the amount of brackets and allowances of the income tax applicable to individuals is also changed.

II. GENERAL ASPECTS OF ARGENTINE INCOME TAX

A. General description

The income tax is applicable to corporations, other legal entities and individuals, regardless of their nationality, domicile or residence.

In general the tax is levied on income from Argentine sources only.

Companies are taxed at a fixed rate of 33% and individuals on a progressive scale between 7 and 45%. Permanent establishments belonging to entities constituted abroad pay 45%.

The income of partnerships is in general taxed in the hands of members, irrespective of actual distribution.

The income tax law recognizes 4 categories of income sources:

- first category comprises income from land;
- second category comprises income from personal capital assets;
- third category comprises income from enterprises; and
- fourth category comprises income from dependent and independent work.

The source of income, however, is in general relevant for computation purposes only, and the law does not provide for different rates, each one applicable to one category.

B. Taxable income

1. The concept of income

For income tax purposes, the concept of income includes:

(i) returns, rents and gains that can be periodically produced by a permanent source;

(ii) returns, rents, profits and gains (even if there is no periodical production and permanent source) realized by corporations, companies, legal entities, business enterprises and business proprietorships; and
(iii) gains realized from the transfer of movable property subject to depreciation.

2. Income categories

The income tax law divides income sources into 4 categories, as follows:

First category – income from land (not belonging to third category taxpayers). This category includes rental income and any other income realized from the ownership of immovable property.

Second category – income from personal capital assets (not belonging to third category taxpayers). This category includes income such as:
(i) income derived from securities;
(ii) income arising from the renting of chattels or from the transfer of rights;
(iii) royalties;
(iv) life pensions, and gains or participations in life insurances;
(v) any compensation for abstaining from doing something. However, this income is included in the third or fourth category, as the case may be, when the result is the non-performance of a business, industry, profession, occupation or employment;
(vi) income from the final transfer of goodwill, trademarks, patents and similar rights; and
(vii) dividends in cash or in kind distributed to shareholders by stock corporations and partnerships limited by shares established in Argentina.

Third category – income of enterprises. This category includes the following income:
(i) income derived by corporations and limited liability companies;
(ii) income derived by general partnerships, limited partnerships, and partnerships limited by shares established in Argentina; civil associations and foundations established in Argentina, unless otherwise provided for; mixed economy companies and companies belonging to the government; permanent establishments belonging to any societies, companies or enterprises established abroad, or to non-resident individuals; and any other company established in Argentina or proprietorship located therein;
(iii) income derived from the activities of commission agents, auctioneers, consignees and other trade agents not specifically included in the fourth category;
(iv) gains derived from the division of land (loteos) made for urbanization purposes;
(v) gains derived from immovable property built and sold according to Law 13,512 (buildings divided into flats or apartments); and
(vi) any income not included in other categories.

Fourth category – earnings from employment and personal work such as earnings from public positions of authority, employment earnings, retirement earnings, professional earnings, earnings from the rendering of personal services to cooperative societies, earnings of directors, managers and executives of corporations and earnings of brokers, travelling agents and customs agents.

Although Argentine law does classify income into different categories, the source of income is in general relevant for computation purposes only. The law does not provide for different rates, each one applicable to one category, but the income tax is normally levied on total income at rates which vary for entities and individuals. Nevertheless, as regards income from capital, it is necessary to consider that capital may be subject, in the case of entities, to the net worth tax (Impuesto a los capitales) or, in the case of individuals, to the net wealth tax (Impuesto al patrimonio).

3. Exempt income

Article 20 of the Income Tax Law lists several items of income which are exempt from income tax. The list was amended by the tax reform of 1985 and includes the following:

(i) adjustments of credits for inflation; this exemption is revoked after 31 December 1986, but the Executive Branch can extend that term. This income is taxable if derived by taxpayers subject to the global adjustment of income for inflation. The adjustment of debt claims representing income to be allocated to the taxable period of collection is exempt only for the adjustment computed as from the date in which the collection is due, the same applies to exchange differences;
(ii) gains from sales, exchanges (cambios); barters (permutas) or transfers of shares, documents (títulos), bonds and other securities derived by individuals and undivided inheritances, even if they perform such transactions habitually (note that these gains are subject to capital gains tax); this exemption does not cover income derived by commission agents, auctioneers, consignees and other trade agents (auxiliares de comercio) not specifically included in the fourth category;
(iii) gifts, inheritances, legacies, any other gratuitous income (enriquecimiento) and gains subject to the tax on games and sporting contests;
(iv) income from securities issued by official or semi-official entities on behalf of the national, provincial or municipal governments when specifically exempted by law or by the Executive Branch; this income is taxable if derived by taxpayers subject to the global adjustment of income for inflation;
(v) indemnities according to seniority on dismissal from work;
(vi) indemnities and insurance because of death or incapacity caused by accident or illness;
(vii) indemnities for the expropriation of property;
(viii) interest on different kinds of deposits in financial institutions subject to the provisions of Law 21,526; this exemption is revoked after 31 De-

cember 1986, but the Executive Branch can extend that term. This income is taxable if derived by taxpayers subject to the global adjustment of income for inflation; interest on deposits indexed for inflation or denominated in foreign currency is also taxable as from 11 October 1985;

(ix) interest received on insurance policies;

(x) interest from broker operations effected by financial institutions. This income is taxable if derived by taxpayers subject to the global adjustment of income for inflation. This exemption is revoked after 31 December 1986, but the Executive Branch can extend that term;

(xi) interest on development loans granted by international institutions or by foreign official institutions, under the limits established by the regulation;

(xii) interest on foreign credit granted to finance imports of movable fixed assets subject to depreciation other than cars, or parts, materials and components for their construction in Argentina. The kind of activity developed by the enterprise or the section thereof to which the assets are destined is irrelevant for purposes of the exemption. The exemption covers the original financing, refinancing granted to the seller, financing obtained through the seller or directly by the purchaser or importer in Argentina, provided the financing is exclusively used for the eligible imports;

(xiii) interest on foreign credit granted to the national treasury, provinces, municipalities or the Central Bank;

(xiv) lease value of owner-occupied dwelling houses;

(xv) premiums derived by stock companies, limited liability companies, limited partnerships and partnerships limited by shares from contributions to their capital;

(xvi) refund of certain taxes granted to exporters by the Executive Branch of the national government;

(xvii) royalties and other income from copyrights derived by the author or by his heir, provided:
- the tax is directly applicable to the author or his heirs;
- the copyright is duly registered with the National Registry of Copyrights;
- the income originates from the publication, execution, representation, exhibition, transfer, translation or other kind of reproduction and not from work ordered by a client or carried out for rendering a service; and
- the recipient is resident in Argentina; and

(xviii) stock dividends; for distributions voted after 11 October 1985 it is necessary for the dividend to be exempt that the recipient identifies himself upon collection of the dividend.

When the taxpayer receives income mentioned in (i), (viii) and (x), but at the same time is subject to the payment of interest and/or indexation, the exemption is limited to that part of such income which exceeds such payments. The same exemptions are revoked after 31 December 1986, but the Executive Branch can extend that term.

Income may also be exempt under tax incentive measures granted in order to promote economic activities which are considered to be of interest for the country.

As regards exemptions and similar benefits, it is necessary to take into account that their enjoyment is limited by the following rules:

– Income tax exemptions and reductions (whether total or partial) will be enjoyed as far as they do not involve the transfer of revenue to a foreign treasury (the relevant proof must be provided by the taxpayer).
  This limitation shall not apply to the following exempt income:
  (i) income from securities issued by official or semiofficial entities on behalf of the national, provincial or municipal governments when specifically exempted by law or by the Executive Branch;
  (ii) interest on foreign loans granted to finance imports for the industrial equipment of Argentina;
  (iii) interest on foreign loans granted to the national, provincial or municipal governments or to official banks;
  (iv) stock dividends paid or credited to beneficiaries abroad; and
  (v) income expressly governed by tax treaties. This means that foreign beneficiaries who receive Argentine-source income in a country which has signed a treaty with Argentina for the avoidance of double taxation are not subject to any restrictions with regard to their entitlement to the tax exemptions available under Argentine laws.

– Income tax exemptions (whether total or partial) established or to be established in special laws in favor of documents, bills, bonds and other securities issued by the national, provincial or municipal governments will not benefit stock corporations and other entities and persons referred to by third category rules.

C. Territorial scope

1. General allocation rules

Argentine legislation is based on the source principle; for this reason it only taxes income derived from sources located in Argentina.

In accordance with the source principle, income derived from sources located abroad is, in principle, not subject to tax. However, income derived by persons living abroad but working for the Argentine central, State or local governments is deemed to be income from Argentine sources. The same applies to income derived by Argentine officials working in international organizations of which Argentina is a member State. Other foreign-source income is exempt from Argentine income tax.

2. Concept of Argentine-source income

Generally, income derived from property situated, located or economically used in Argentina, from the development in Argentina of acts or activities that may produce income, or from events occurring in Argentina is considered Argentine-source income. The nationality, domicile or residence of the income's beneficiary or of the parties to the transactions, and the place where contracts are concluded, are immaterial for the aforesaid purposes.

Income specifically considered to be Argentine-source includes:

(i) interest on mortgages, if the real estate subject to the mortgage is located in Argentina (if the real estate is not so located, the interest may still be considered to be Argentine-source under the rules discussed above);
(ii) interest from bonds, if the issuing institution is established or located in Argentina;
(iii) income from exported goods produced, manufactured, processed or bought in Argentina;
(iv) income from imported goods in excess of their normal wholesale price in the country of origin, increased by transportation and importation expenses;
(v) income from the transfer of goods situated, located or economically used in Argentina that belong to enterprises or companies organized, established or located abroad;
(vi) receipts from insurance and reinsurance operations covering risks located in Argentina or referring to persons who have resided in Argentina;
(vii) compensation paid to members of boards of companies and other entities incorporated in Argentina, even for work performed abroad;
(viii) fees and other remuneration derived from technical, financial and other assistance provided from abroad which is economically used in Argentina; and
(ix) dividends and participations in profits when paid or distributed by legal entities domiciled in Argentina.

3. Avoidance of double taxation

(a) *Unilateral measures*

The income tax applies, as a rule, only to Argentine-source income. In case of occasional personal activities performed abroad by resident individuals, the income arising therefrom is taxable, but taxpayers may compute, as a payment on account of Argentine income tax, the tax charged abroad on such income; the tax credit, however, may not exceed the increase in fiscal burden derived from the inclusion of foreign-source income.

(b) *Treaty measures*

Argentina has signed several comprehensive treaties for the avoidance of double taxation of income, namely: with Austria (in force from 17 January 1983); Bolivia (in force from 1 January 1980); Brazil (in force from 7 December 1982); Chile (not yet in force); France (in force from 1 March 1981); the Federal Republic of Germany (not yet in force); Italy (not yet in force); Sweden (not yet in force); and the U.S.A. (not yet in force).

Argentina has also signed several treaties for the avoidance of double taxation of income from international shipping and/or air transportation.[1]

D. Taxable period and allocation of income

1. Taxable period

For most income tax purposes, the tax year (ejercicio anual) coincides with the calendar year (año fiscal), that is, it starts on 1 January and ends on 31 December. However, enterprises whose tax years (ejercicios anuales) do not correspond to the calendar year (año fiscal) are taxed according to their tax years.

If transactions are not registered in accounting records, the tax year (ejercicio) shall be the same as the calendar year (año fiscal), unless the tax administration fixes a special closing date considering the nature of the venture or other particular circumstances.

2. Allocation of income

In allocating profits and expenses, recipients of third category profits shall use the accrual method.

Installment sales are in principle allocated on an accrual basis. However, in the case of sales with terms exceeding 10 months, the taxpayer can choose to report income derived therefrom when it becomes due. This election must be maintained for 5 years.

Recipients of first category income must use the accrual method and recipients of second and fourth category income must use the cash method.

Dividends from shares and interest on documents, bonds and other securities are allocated to the tax year (ejercicio) in which they are put at the recipient's disposal.

Directors, controllers and members of the audit committee shall allocate their fees to the calendar year (año fiscal) in which the fees are approved by the assembly of shareholders.

In certain cases, payments made by foreign controlled local enterprises representing Argentine-source taxable income for the recipient are allocated to the taxable period in which they are paid or to the taxable period of accrual, provided in this last case they are paid within the term for filing the income tax return. This rule applies if:

(i) the payment is made to a company, person or group of persons from abroad that participates, directly or indirectly, in the capital, control or management of the payer;
(ii) the payment is made to an enterprise or establishment abroad, provided a company, person or group of persons from abroad participates, directly or indirectly, both in the capital, control or man-

1. For further information please consult the Bureau's loose-leaf publication, *Corporate Taxation in Latin America*.

agement of the payer and in the capital of the recipient; or
(iii) the payment is made to an enterprise or establishment in the capital of which the local payer participates directly or indirectly.

III. TAXATION OF RESIDENT COMPANIES

A. General description and taxable persons

Corporations established in Argentina are subject to the rules of the Income Tax Law, especially to those concerning third category income.

The same rules specifically apply to: limited liability companies, limited partnerships and partnerships limited by shares, all of them established in Argentina; civil associations and foundations established in Argentina, unless otherwise provided for; companies belonging to the government; permanent establishments belonging to any societies, companies or enterprises established abroad, or to non-resident individuals; any other company established in Argentina or proprietorship located therein; and commission agents, auctioneers, and consignees.

The income of corporations, partnerships limited by shares (in that part belonging to limited partners) and permanent establishments of foreign enterprises is taxed in the hands of the respective entities at a 33% rate. The income of corporations may also be taxed upon actual or presumed distribution to individuals or to non-residents.

Income of proprietorships, general partnerships, limited liability companies, limited partnerships and partnerships limited by shares, for that part belonging to managing partners, is only taxed in the hands of the partners or owners, irrespective of actual distribution.

B. Taxable income

1. The concept of income

As stated above, the concept of income includes:
(i) returns, rents and gains that can be periodically produced by a permanent source;
(ii) returns, rents, profits and gains (even if there is no periodical production and permanent source) realized by corporations, companies, legal entities, business enterprises and business proprietorships; and
(iii) gains realized from the transfer of movable property subject to depreciation.

Thus, the concept of income, while being limited to recurring income for taxpayers in general, is extended in the case of corporations and other taxpayers mentioned in (ii) above (this Section). For them, income subject to tax includes all Argentine-source income with the exception of gains subject to the tax on games and sporting contests.

2. Exempt income

As explained in II B.3. above, income may be exempt in accordance with Article 20 of the Income Tax Law or under tax incentive measures.

C. Valuation of assets

1. Valuation of inventory

Argentine law provides for several rules for the valuation of inventory, which were amended by the tax reform of 1985. The new rules are discussed below and, in general, are mainly based on the market cost at the end of the year.

Merchandise for resale, raw material and materials are valued at the cost of the last purchase made during the 2 months preceding the closing of the tax year (ejercicio). If no purchase has been made during such 2 months, the cost of the last purchase made in the tax year (ejercicio), if any, is taken as adjusted between the dates of purchase and closing of the tax year (ejercicio) in accordance with changes in the wholesale price index general level. If no purchases are made during the tax year (ejercicio), the value registered for fiscal purposes in the opening inventory is taken as adjusted between opening and closing dates in accordance with changes in the wholesale price index general level.

Products are valued at the price of the last sale made during the 2 months preceding the closing of the tax year (ejercicio), as reduced by sales expenses and the net profit margin included in such a price. If no sales are made during such 2 months, the price of the last sale made during the tax year (if any) is taken, as reduced by sales expenses and the net profit margin included in such a price and adjusted in accordance with changes in the wholesale price index general level, between the dates of sale and closing the tax year (ejercicio). If no sale is made during the tax year (ejercicio), the taxpayer's sale price at the closing of the tax year (ejercicio) is taken, as reduced by sales expenses and the net profit margin included in such a price.

If the taxpayer keeps a system that allows for the determination of the production cost of each group (partida) of manufactured products (productos elaborados), then the method established for the valuation of inventory of merchandise for resale shall be used for the valuation of products, treating the end of the manufacture as purchasing date. In these cases the allocation of raw material and material to processing is made, considering the method established for the valuation of inventory for such goods.

Unfinished products are valued by applying the percentage of completion at the closing of the tax year (ejercicio) to the value established under the above rules.

If the taxpayer can clearly prove (probar en forma fehaciente) that the market cost at the end of the tax year (ejercicio) is below the value established under the aforegoing rules, inventory can be valued at the market cost. In this case, it is necessary to report to the tax administration about the method used when filing the income tax return.

Global deductions made when valuing inventory, in order to establish general reserves that cover price fluctuations or other contingencies, are not permitted.

2. Valuation of real property in trade

Immovable property and construction work representing stock in trade is, after the tax reform of 1985, valued under the following rules:

(i) the value of immovable property acquired by the taxpayer is the acquisition value, including necessary expenses, updated between the date of purchase and the closing date of the tax year (ejercicio);
(ii) the value of immovable property constructed by the taxpayer is the value of land determined according to (i), as increased with construction costs as duly updated between the date of conclusion of the construction and the closing date of the tax year. In establishing construction cost, investments made in the construction shall be updated between the date in which each investment was made and the date of conclusion of the construction;
(iii) the value of construction work not finished yet is the value of the land determined according to (i) as increased with investments, which are adjusted between the date in which the investment was made and the closing date of the tax year; and
(iv) the value of the improvements is determined by updating each investment between the date in which the investment was made and the date of conclusion, and the result is updated between the conclusion date and the closing date of the tax year.

In the case of sale, the allowed cost is equal to the value for fiscal purposes established in the opening inventory corresponding to the tax year in which the sale is made. Investments made between the beginning of the tax year and the date of sale shall be added to the cost, without updating.

If the taxpayer can clearly prove (probar en forma fehaciente) that the market cost at the end of the tax year (ejercicio) is below the value established under the aforegoing rules, immovable property in trade can be valued at the market cost. In this case, it is necessary to report to the tax administration about the method used when filing the income tax return.

D. The computation of taxable income

1. General description

In computing taxable income, it is first necessary to establish gross income by deducting from sales proceeds the cost of goods sold. It is then necessary to establish net income by deducting from gross income the business expenses, that is to say, the expenses which are necessary to obtain or to maintain and preserve the source of income. Later on, net income is further adjusted for inflation, resulting in taxable income.

2. Sales proceeds

The starting point for the computation of taxable income is sales proceeds from which costs and business expenses must be deducted in the computation of taxable income.

Net sales proceeds are calculated by deducting from gross sales proceeds, restitutions, bonuses, discounts and similar items, in accordance with market practices.

Stock corporations and other entities and persons referred to by third category rules are required to include in taxable receipts income derived from documents, bills, bonds and other securities issued by the national, provincial or municipal governments without considering income tax exemptions.

3. Costs

In order to calculate gross income it is necessary to deduct from sales proceeds the cost of the goods sold as established in accordance with standard regulations regarding inventory valuation.

The cost of assets subject to depreciation is adjusted under updated indexes prepared by the tax administration. The cost is further adjusted by deducting depreciation allowances.

4. Business expenses and other deductions

(a) *Expenses in general*

For the calculation of net income it is necessary to deduct from gross income the expenses which are necessary to obtain the income or to maintain and preserve the source of income.

Deductions are ruled by the "principle of causality", which means that expenses are deductible insofar as they relate to taxable income.

Expenses incurred to obtain non-taxable income, however, are in principle non-deductible.

In principle, only expenses incurred in Argentina are allowed as a deduction for calculating taxable income, but the deduction of expenses incurred abroad is also allowed if the taxpayer proves that these expenses have been made in order to obtain profits from an Argentine source. Moreover, commissions and expenses incurred outside Argentina related to Argentine-source income from exportation are allowed as a deduction.

Where expenses are incurred to obtain taxable and non-taxable income (the latter includes foreign-source income and tax-free income), they shall be apportioned and will only be allowed as a deduction in the proportion which is related to taxable income. The apportionment will be made on a gross income basis, but any other method may be accepted if it proves to be more rational.

In order to take advantage of the expense deduction, expenses must be duly proven.

The law also provides that, under certain limits and conditions, the deduction of some items is specifically allowed in the computation of third category income (business profits).

The following discussion shall cover only those specific deductions which have been amended by the reform, i.e. interest, salaries, entertainment expenses, directors' fees, profit distributions, depreciation of buildings and losses.

(b) *Interest*

Interest on debts, their appreciation due to inflation and expenses of original financing, refinancing or cancelling debts is specifically allowed as a deduction under the old rules.

The tax reform of 1985 provides that in the case of individuals and undivided inheritances that cannot demonstrate that interest and other items referred to are incurred to obtain, maintain or conserve taxable income, the deduction is limited to that part of it which proportionally corresponds to the percentage that income producing net worth bears to total net worth, as increased with goods that have been disposed of or consumed.

(c) *Salaries and other employment income*

Salaries and other remuneration paid to employees are deductible under old rules provided the payments are not excessive. Payments made after the end of a taxable year for services rendered during the taxable year are deductible in the year in which the services were rendered, provided they are paid before the date established for filing the tax return.

The reform provides that the remuneration paid to the taxpayer's spouse or relative for services actually rendered is deductible in that part not exceeding both the remuneration usually paid to third persons for the same services and the remuneration paid to the non-relative employee placed in the enterprise's highest position; however, the tax administration may rule otherwise.

(d) *Entertainment expenses*

Entertainment expenses are deductible within a limit of 5% of remuneration paid to employees, and provided they are actually incurred and duly proved.

(e) *Directors' fees*

Sums destined by stock corporations and partnerships limited by shares to the payment of fees to members of boards of directors, controllers or members of the audit committee are deductible up to the higher of:
- 25% of accounting profits of the tax year (ejercicio); or
- 5,000 australes per each recipient of the fees. This amount is to be adjusted every month by the tax administration on the basis of changes in the wholesale price index, general level. The adjustment for the closing month is calculated by comparing the average of monthly indexes of the corresponding calendar year (ejercicio fiscal anual) with the same average of the preceding calendar year (ejercicio fiscal anual). The limit calculated for the closing month is used for the entire calendar year (período fiscal).

(f) *Profit distributions*

Sums withdrawn by the taxpayer or partner of sole proprietorships, general partnerships, limited partnerships, limited liability companies and partnerships limited by shares, in that part belonging to general partners, in the form of profits, salary or under any other category involving a withdrawal of income, are disallowed as a deduction. Any of such sums that is deducted shall be added to the participation of the owner or partner to whom it corresponds.

(g) *Depreciation of buildings*

Depreciation is allowed on buildings and other constructions made on immovable property when they are destined to activities or investments that produce income subject to tax. Such depreciation is calculated on the cost at a 2% rate. A higher percentage can be accepted when sufficient proof is provided to demonstrate that the useful life is less than 50 years and notice is given to the tax administration with the filing of the income tax return corresponding to the first calendar year (ejercicio fiscal) in which the higher percentage is used.

(h) *Losses*

Rules concerning losses have been changed for (i) combined or total losses and (ii) losses from the transfer of shares.

(i) In order to establish the combined or total net income, net results derived during the calendar year (año fiscal) from different categories are compensated with each other. The combined loss incurred in a year may be carried forward to be offset against taxable income of other years up to 5 years from the year in which the loss was incurred. Losses to be set off against future profits are adjusted for inflation in accordance with changes in the wholesale price index, occurring between the month of closing of the period in which they were incurred and the month of closing of the period in which they are liquidated. Losses may not be carried back. Personal allowances granted to individuals cannot be added to the calculation of losses.

(ii) Losses incurred by stock corporations and other entities and persons referred to by third category rules, upon the transfer of shares, ownership interests in companies (cuotas o participaciones sociales) and shares in common investment funds, can be offset against net income derived from the transfer of similar property. These losses may be carried forward, as adjusted for inflation, up to 5 years from the year in which the loss was incurred to be offset against income derived from the same kind of transactions.

5. Adjustment of income for inflation

(a) *General*

Law 21,894 of 27 October 1978 amended the income tax law and introduced the adjustment of taxable income for inflation. Important changes were introduced later on by the tax reform of 1985, i.e. by Law 23,260 published in Official Bulletin of 11 October 1985.

In the message attached to Law 21,894 the adjustment is described as permanent, global, general and compulsory. Nevertheless, the scope of the adjustment has some limits of which the most important is that, in general, it covers current assets only (monetary assets and inventory).

The global adjustment is applicable to income derived by stock corporations and other entities and persons referred to by third category rules (see II B.2.).

(b) *Computation of the adjustment base*

In order to calculate the adjustment it is necessary to consider the difference between assets and liabilities according to their values at the end of the period preceding that which is being corrected.

For the aforesaid purposes, certain items are excluded from assets (some of them are adjusted separately), namely:

(i) real property and work in course thereon, except for those representing goods for sale (bienes de cambio); their cost is adjusted separately upon sale (see III E.5(b));
(ii) investments in materials destined to works referred to in (i);
(iii) movable goods subject to depreciation under the income tax law, inclusive of reproducer animals subject to depreciation; their cost is adjusted separately upon sale (see III E.5(b));
(iv) movable goods being processed and destined to be incorporated in fixed assets;
(v) intangible goods;
(vi) wood in the case of forestry exploitation (either converted timber or standing wood);
(vii) shares and ownership interests and participations in companies, including shares in investment funds;
(viii) investments abroad, including financial placements, not producing Argentine-source income or not used in activities producing Argentine-source income;
(ix) movable goods not subject to depreciation (e.g. artistic works, yachts and other personal property not producing income), except for securities and stock-in-trade (bienes de cambio);
(x) debt claims representing signs or sums advanced before the acquisition of goods listed from (i) through (ix) in order to freeze the price;
(xi) contributions made and sums advanced on account of future capital contributions, provided there is a duly documented or irrevocable engagement of share subscription, except for those that earn interest or indexation under terms similar to those that may be agreed between independent parties under normal market practices;
(xii) pending contributions to be made by shareholders;
(xiii) sums due by the owner or partner for pending contributions or for transactions concluded under terms which are different from those that may be agreed between independent parties under normal market conditions;
(xiv) in case of foreign controlled local enterprises, sums due by a person or group of persons abroad that participate, directly or indirectly, in the capital, control or management of the local enterprise if the owed sum originates from contracts the terms of which are different from those that may be agreed between independent parties under normal market practices;
(xv) establishment, organization and reorganization expenses, as well as development, study and research expenses, as far as they were allowed as a deduction;
(xvi) non-deductible expenses and advance payments of non-deductible taxes included in assets; and
(xvii) stock-in-trade that, during the taxable period, is transferred to fixed assets.

If goods listed in (i) through (vii) are transferred during the taxable period, the book value they had at the beginning of the tax year is not excluded from assets.

The liabilities to be deducted from assets are:

(i) liabilities in general; reserve funds (provisiones y previsiones) are deductible in those cases and within the limits in which they are allowed in the computation of taxable income;
(ii) income (utilidades) received in advance and income representing gains to be collected in future periods;
(iii) fees and bonuses (gratificaciones) deducted in the period for which they are paid.

For adjustment purposes some items are excluded from liabilities, namely:

(i) advance payments received on account of future capital contributions, when there is a duly documented or irrevocable engagement of share subscription which in no case earn interest or indexation for the contributor;
(ii) sums owed to the owner or partner for transactions concluded under terms which are different from those current in the market for independent parties; and
(iii) in the case of foreign controlled local enterprises, sums owed to persons or group of persons abroad that participate directly or indirectly in the capital, control or management of the local enterprise, if the owed sum originates from contracts the terms of which are different from those that may be agreed upon between independent parties under normal market practices.

(c) *Valuation rules*

As stated before, in order to calculate the adjustment it is necessary to consider assets and liabilities according to their values at the end of the period preceding that which is being corrected.

There are, however, some items referred to below which, for the computation of the adjustment, are valued under special rules.

Deposits, debt claims (créditos) and debts denominated in foreign currency, and inventory of foreign currency are valued in accordance with the last quotation (for purchases or sales, as the case may be) in the National Bank of Argentina (Banco de la Nación Argentina) on the closing date, including interest accrued up to that date.

Deposits, debt claims and debts in Argentine currency are valued in accordance with their amount on the closing date, including interest and indexation established in the law, a contract or a court decision, accrued up to that date.

Government documents (títulos públicos) bonds and securities, including those denominated in foreign currency are quoted on stock exchanges (bolsas o mercados), are valued in accordance with the last quotation on the closing date. Those that are not quoted are valued at cost as increased with interest, indexation and exchange differences accrued up to the closing date.

(d) *Computation of the adjustment*

After the reform of 1985, the adjustment is computed in two stages and is equal to the combined result thereof. The first stage deals with net worth at the end of the period preceding that which is being corrected. The second stage relates to changes in assets and liabilities during the period which is being adjusted.

The difference in value between assets and liabilities, computed under the rules referred to above, is adjusted in the same proportion as the increase of the wholesale price index general level between the end of the period preceding that which is being adjusted, at the end of the period which is being adjusted.

The adjustment is deemed to be "negative" when assets exceed liabilities and "positive" when assets are less than liabilities.

The adjustment resulting from the above rules is further increased or reduced, as the case may be, by the adjustments corresponding to changes during the taxable period, namely:

(i) it is increased by a positive adjustment corresponding to the adjustment of, for example, withdrawals made by owners or partners, funds or goods transferred without proper consideration; dividend distributions (except for stock dividends), capital reductions, fees paid in excess of the limits established in the law, and acquisition of goods excluded from the adjustment base; and

(ii) it is reduced by a negative adjustment corresponding to the adjustment of, for example, contributions of any kind received by the enterprise, capital increases, certain investments abroad, and certain transfers.

The amount computed under the aforegoing rules is the adjustment for inflation which if "positive" increases the income or reduces the loss, and if "negative" reduces the income or increases the loss.

(e) *Taxation rules*

If the taxpayer's tax records, after the computation of the "positive" adjustment for inflation and after the deduction of losses carried forward from previous periods, show a profit, the lower of the "positive" adjustment for inflation or net income can be spread by the taxpayer over 3 consecutive calendar years (períodos fiscales) (including the period which is being adjusted), provided the distribution of profits (other than stock dividends) is postponed.

For this purpose, in the case of sole proprietorships, general partnerships, limited partnerships, limited liability companies, partnerships limited by shares, commission agents, auctioneers, consignees and similar persons, a distribution or withdrawal of profits is deemed to exist when the amount of such distributions or withdrawals exceed, in the corresponding tax year (ejercicio), 3 times the basic personal allowance (ganancia no imponible) of the owner or of each partner.

The amounts that are deferred shall be adjusted in accordance with Law 21,281 on the basis of changes in the index between the closing month of the tax year (ejercicio) in which the adjustment was made and the closing month of the tax year (ejercicio) to which the installment is allocated.

If during the periods following the period in which the taxpayer decided to spread the corresponding sum over 3 years, as aforesaid, a loss for tax purposes is incurred, that loss shall be reduced:

- by the installments of "positive" adjustments from previous periods to be allocated to the period in which the loss is incurred; and
- by the installments of "positive" adjustments from previous periods to be allocated to periods following the period in which the loss was incurred.

Taxpayers subject to the global adjustment for inflation shall include, in their profits or losses, the sums originating from the indexation of debt claims, debts or securities (other than shares) established in a law, contract or court ruling, computed between the beginning of the period (acquisition date if acquired during the period) and the end of the period. For securities quoted in the stock exchange, the quotation is taken.

As regards deposits, inventory, debt claims and debts denominated in foreign currency, taxpayers subject to the adjustment of income for inflation shall also include in their profits or losses the results derived from changes in the foreign exchange rate occurred between the end of the preceding period (acquisition date if acquired during the period) and the end of the taxable period.

Exemptions, whether complete or partial, already established or that may be established in the future through special laws as regards documents (títulos), bills, bonds and securities issued by the central government, provinces or municipalities, shall not be enjoyed by stock corporations and other entities and persons referred to by third category rules (see II B.2.).

E. The computation of the tax

1. Tax rates

The net taxable profits of resident corporations and partnerships limited by shares, in that part belonging to limited partners, are subject to income tax at a flat rate of 33%, provided such entities have been incorporated in Argentina.

Net taxable income of general partnerships, limited liability companies, limited partnerships and partnerships limited by shares (in that part belonging to general partners) is deemed to be automatically distributed and subject to tax in the hands of the recipient only.

Net taxable income of permanent establishments belonging to any entities and enterprises established abroad or to non-resident individuals is subject to income tax at a 45% flat rate.

Non-resident individuals, corporations, companies and other entities are subject to a 45% withholding tax on net profits received, except for dividends which are taxed at other rates (17.5% or 22.5%).

2. Tax credits

Taxes withheld at source and advance payments are credited against the final tax. If taxable income includes income from transfers subject to the tax on transfer of securities, such a tax can, after the 1985 tax reform, be credited against the income tax, up to a limit of:
- 33% for stock corporations and partnerships limited by shares, in that part belonging to limited partners; and
- 15% for other taxpayers.

F. Taxation of particular items of income

1. Dividends

Dividends paid to stock corporations, partnerships limited by shares, civil associations or foundations, companies belonging to the government and permanent establishments belonging to non-residents are not included in the taxable income of the recipient.

2. Interest

The taxation of interest has not been changed by the reform.

In general, interest is taxed as ordinary income and is subject to withholding tax at source.

The rate of the withholding depends on whether the payer is a financial institution or not and on whether the recipient is registered with the tax administration or not, namely:
- if the payer is a bank, financial institution or stock exchange agent and the recipient is registered with the tax administration, the rate is 3%;
- if the payer is a bank, financial institution or stock exchange agent and the recipient is not registered with the tax administration, the rate is 7%;
- if the payer is not a bank, financial institution or stock exchange agent and the recipient is registered with the tax administration, the rate is 7% and is applied on the amount exceeding a certain minimum; and
- if the payer is not a bank, financial institution or stock exchange agent and the recipient is not registered with the tax administration, the rate is 25% and is applied on the amount exceeding a certain minimum.

The withholding tax may be credited against the income tax.

The withholding of the tax is not applicable in specified instances, which include interest:
- paid on different kinds of deposits in financial institutions subject to the provisions of Law 21,256; this income is taxable if derived by taxpayers subject to the global adjustment of income for inflation;
- from brokerage operations of financial institutions; this income is taxable if derived by taxpayers subject to the global adjustment of income for inflation;
- paid on the price of balance of sales made on credit or paid in arrears;
- paid to shareholders or partners of companies organized in Argentina;
- presumed on sales on credit;
- paid or credited on deposits in foreign currency;
- paid or credited on deposits required for imports or otherwise required by the law; and
- paid to insurance companies, capitalization companies, public utilities, transportation enterprises or banks.

3. Royalties

The taxation of royalties has not been changed by the reform.

Royalties paid to third category taxpayers are subject to income tax under general rules for third category taxpayers.

Residents who habitually develop research in order to obtain assets which may produce royalties must also calculate their income under third category provisions.

Royalty payments exceeding a certain sum are subject to withholding of income tax at source on their gross amount.

In the case of payments to companies and sole proprietorships that adjust their income for inflation (global adjustment), the withholding tax is also applied on sums representing the indexation of the royalty.

The rate of the withholding depends on whether the recipient is registered with the tax administration or not, namely:
- if the recipient is registered with the tax administration the rate is 7%; and
- if the recipient is not registered with the tax administration the rate is 25%.

The withholding tax does not apply to royalties paid to insurance companies, capitalization companies, public utilities, transportation enterprises or banks.

4. Service fees

The taxation of services was not changed by the reform.

Service fees paid to third category taxpayers are subject to income tax under the general rules for third category taxpayers.

Service fees exceeding a certain sum are also subject to withholding of income tax at source.

In the case of payments to companies and sole proprietorships that adjust their income for inflation (global adjustment), the withholding tax is also applied on sums representing the indexation of the fee.

The withholding tax does not apply to:
- commissions and other remuneration paid to publicity agencies;
- remuneration of construction works (locaciones de obra);
- service fees paid to insurance companies, capitalization companies, public utilities, transportation enterprises or banks.

The rate of the withholding depends on whether the recipient is registered with the tax administration or not:
- if the recipient is registered with the tax administration the rate is 7%; and
- if the recipient is not registered with the tax administration the rate is 25%.

5. Capital gains

(a) *Taxation rules*

Capital gains are subject in Argentina to different tax regimes according to the person, activity and property which is involved.

The following gains are subject to normal income tax under ordinary rules:
(i) gains derived by:
  - any kind of company;
  - permanent establishments belonging to entities organized abroad or belonging to non-resident individuals;
  - sole proprietorships;
(ii) gains derived from the division of land (loteo) made for urbanization purposes; and
(iii) gains derived from immovable property built and sold according to Law 13,512 (buildings divided into flats or apartments).

Gains from the transfer of movable depreciable assets other than securities are subject to income tax under general rules irrespective of the recipient, but the cost of the assets is adjusted for inflation when calculating the profit.

Companies have the option of treating the results from the sale of depreciable assets as a profit or loss for the financial year, or they may defer income taxation by deducting the profits on sale from the cost of the new asset.

However, in order to defer taxation on gains derived from the transfer of immovable property, it is necessary to reinvest the entire proceeds derived from the transfer.

In the case of stock corporations and other entities and persons referred to by third category rules (see II B.2.), gains from the transfer of shares, bonds, debentures and securities are also subject to income tax under general rules.

(b) *Computation of income*

When movable property subject to depreciation is sold, gross income is determined by deducting from the sale price, the cost established according to the following rules:
(i) the cost of goods acquired by the taxpayer is the acquisition cost, as updated in accordance with indexes prepared by the tax administration on the basis of changes in the wholesale price index, general level, between the date of purchase and the date of sale and reduced by depreciation allowances calculated on the updated values; and
(ii) for goods processed, produced or constructed by the taxpayer, the processing cost, production cost or construction cost is determined by updating each sum invested between the date of the investment and the date of conclusion of the processing, production or construction. The result is updated between this last date and the date of sale and reduced by depreciation allowances calculated on updated values.

The gross income from the sale of immovable property not representing stock-in-trade is determined by deducting, from the sale price, the cost computed under the following rules:
(i) the cost of immovable property acquired by the taxpayer is the acquisition cost, including expenses necessary for the transaction, as updated between the date of purchase and the date of sale;
(ii) for immovable property constructed by the taxpayer, the value of the land determined under (i) above, is increased by the construction cost updated between the date of conclusion of the construction and the date of sale; for this purpose the construction cost is established by updating each investment between the date in which the invest-

ment was made and the date of conclusion of the construction; and

(iii) for construction work (not concluded yet), the value of land determined under (i) plus investments, as adjusted between the date in which each one was made and the date of sale, is taken.

If the property which is sold was used for activities or investments producing taxable income, the value resulting from the aforegoing computations is reduced by depreciation allowances corresponding to the periods during which the property was used for such activities.

Gross income from the transfer of goodwill, trademarks, patents, concession rights and other similar assets, is established by deducting from the sale price the acquisition cost as updated between the date of purchase and the date of sale. The result is reduced by amortizations calculated on the updated values.

Gross income derived from the transfer of shares, ownership interests or participations in companies, including shares in common investment funds, is determined by deducting from the transfer price the acquisition cost, updated in accordance with changes in the wholesale price index, general level, between the date of acquisition and the date of transfer. In the case of stock dividends, the acquisition cost is the updated face value (valor nominal). For allocation purposes, the f.i.f.o. method is used. No cost is computed in the case of transfer of shares received as exempt dividends as from taxable periods beginning after 4 October 1985.

When public documents (títulos públicos), bonds and the other securities are sold, the deductible cost shall be equal to the value for fiscal purposes appearing in the opening inventory of the tax year (ejercicio) in which the sale was made. If the acquisition was made during the tax year, the cost is the price of purchase. For allocation purposes the f.i.f.o. method is used.

When profits are derived from the sale of non-specified goods (other than stock in trade) the result is established by deducting, from the value of sale, the acquisition, production or construction cost and the amount of improvements.

IV. TAXATION OF RESIDENT INDIVIDUALS

A. Taxation of total income

1. General description

As stated before, the general income tax is levied at different rates for individuals and legal entities.

Individuals and undivided inheritances are subject to income tax on their total income at progressive rates, as shown in Table 1.

Non-taxable minimum income and the brackets of the income tax scale for individuals are automatically and annually corrected by applying official indexes. These indexes are specified by the tax administration on the basis of data provided by the statistics agency. The coefficient of the updating is calculated considering the change in the wholesale price index, general level, by comparing the average of the monthly indexes of the corresponding calender year (año fiscal) and the average of the monthly indexes corresponding to the preceding calendar year (año fiscal).

Family and other allowances are annually fixed considering the aggregate of the corresponding monthly amounts.

Similar rules are applicable to the adjustment of allowances and brackets corresponding to withholding taxes levied as an advance payment on employment income.

2. Taxable persons

(a) *Taxable persons in general*

Resident individuals and undivided inheritances are covered by the income tax. The rates are progressive.

(b) *Rules for married couples*

The spouse files a separate return. However, income from property acquired during the marriage (bienes gananciales) is allocated to the husband, except in those cases where:

- the income is derived from property acquired by the wife with proceeds from the exercise of a profession, vocation, employment, commerce or industry;
- the property of the spouses has been separated by a court decision (separación judicial de bienes);
- the administration of the property acquired during the marriage (bienes gananciales) has been charged to the wife by a court decision.

The following income is allocated to the corresponding spouse:

- income from personal activities (profession, vocation, employment, commerce and industry);
- income from property belonging to the spouse;
- income from property acquired with proceeds from the exercise of the spouse's profession, vocation, employment, commerce or industry.

3. Taxable income

(a) *The concept of income*

Individuals and undivided inheritances are subject to income tax on their total income.

Profits derived by sole proprietorships, general partnerships, limited partnerships and limited liability companies are deemed to be entirely allocated to the owner or distributed among partners or members. In the case of partnerships limited by shares, each general partner (socio comanditario) is deemed to have received that part of the profits which corresponds to his interest in the partnership. This means that the owner or partner must include his share of the entity's income in his total income.

(b) *Exempt income*

As explained in II B.3. above, income may be exempt in accordance with Article 20 of the income tax law or under tax incentive measures.

(c) *Allowances*

In computing their taxable income, resident individuals can deduct personal allowances. An individual is considered to be a resident:
- if he was present in Argentina for more than 6 months during the taxable year;
- if he is abroad, but discharges official duties on behalf of the Central Government, provinces or municipalities; or
- if he is an Argentine citizen and discharges duties in international bodies of which Argentina is a member.

The allowances provided by the law are:
- personal allowances
  basic personal allowance (ganancia no imponible) 2,000 australes
- family allowances
  - spouse 1,000 australes
  - dependant ascendant, descendant, brother or sister 500 australes
- expense allowances
  - funeral expenses incurred in Argentina by the taxpayer or his dependents, up to 400 australes
  - life insurance premiums, up to 400 australes
  - contributions made for charitable purposes and premiums paid to institutions that cover medical services to the taxpayer and his family actual amount
- special allowance (deducción especial) deduction from earned income 2,500 australes

4. Computation of the tax

(a) *Tax rates*

After the 1985 tax reform, the income tax is levied on the income of individuals at progressive rates as shown in Table 1.

(b) *Tax credits*

If the taxable income of an individual includes dividends distributed by stock corporations or partnerships limited by shares, the shareholder shall credit, as an advance payment, the increase in the tax liability resulting from the inclusion of such dividends (the credit referred to cannot exceed 27.50% of dividends).

If taxable income includes income from transfers subject to the tax on the transfer of securities, such a tax can be credited against the income tax, up to a limit. In the case of individuals and undivided inheritances the limit is 15%.

Table 1

Individual income tax rates

Taxable base (australes)		*Fixed amount + % on excess*	
——	510	——	7
510	1,200	35.7	8
1,200	1,880	90.9	9
1,880	2,740	152.1	10
2,740	3,770	238.1	11
3,770	5,140	315.4	12
5,140	6,510	515.8	13
6,510	8,570	693.9	15
8,570	11,140	1,002.9	17
11,140	13,710	1,439.8	19
13,710	16,280	1,928.1	21
16,280	19,710	2,467.8	23
19,710	23,990	3,256.7	26
23,990	28,280	4,369.0	29
28,280	32,560	5,614.0	32
32,560	37,700	6,983.6	35
37,700	42,840	8,782.6	38
42,840	51,410	10,735.8	41
51,410	——	14,249.5	45

Note that brackets of the income tax scale for individuals are automatically and annually corrected by applying official indexes.

B. Taxation of particular items of income

1. Business income

Business income of individuals is included in total income and taxed at progressive rates ranging from 7% to 45%, as shown in Table 1.

The owner or partner of a sole proprietorship, general partnership, limited partnership and limited liability company must include his share of the entity's income in his total income.

2. Dividends

(a) *Dividends in general*

Several amendments were introduced by the tax reform concerning the taxation of dividends. Such taxation varies depending on whether the recipient identifies himself upon collection of the dividend or not.

Dividends paid by stock corporations and partnerships limited by shares to resident individuals who identify themselves upon collection of the dividend are not subject to the withholding of the income tax at source. These dividends are included in the aggregate income of the recipient and taxed at progressive rates ranging from 7% to 45%, as shown in Table 1. But, the recipient shall treat the increase in the tax liability resulting from the inclusion of the dividend as an advance payment to be credited against his final liability, up to a limit of 27.5% of the dividend.

Dividends paid to resident individuals who do not identify themselves upon collection of the dividend are subject to a 22.5% withholding tax which is final.

Dividends are taxable irrespective of the company funds out of which they are paid (e.g. reserves irrespective of their establishment, foreign-source income, capital gains, exempt income and so on).

Dividends in kind, other than stock dividends, are computed in accordance with their current market value on the distribution date.

If the distribution of dividends in kind is made with goods, the current market value of which is other than the cost for tax purposes, the aggregated difference is treated as a taxable result of the distributing entity in the year in which the distribution is made.

In the case of dividends in kind, the goods received by the beneficiary may be subsequently subject to income tax or capital gains tax, under ordinary rules, upon their transfer by the beneficiary (taking the market value on the distribution date as cost).

(b) *Stock dividends*

The taxation of stock dividends also varies depending on whether the recipient identifies himself upon collection of the dividend or not.

Stock dividends distributed to persons who identify themselves upon collection of the dividend are exempt from income tax.

Stock dividends paid to persons who do not identify themselves upon collection of the dividend are subject to a 22.5% withholding tax which is final.

Stock dividends derived from duly authorized revaluations or adjustments in the value of goods are not included in the recipient's net income, provided they do not originate from net profits already realized by the company.

(c) *Profits of unincorporated entities (entities other than stock corporations)*

Profits derived by sole proprietorships, general partnerships, limited partnerships and limited liability companies are deemed to be entirely allocated to the owner or distributed among partners or members.

In the case of partnerships limited by shares, the profits are deemed to be distributed in accordance with the percentage of the interest in the partnership's capital belonging to each general partner (socios comanditados).

Losses originating in the transfer of shares or ownership interests in companies cannot be allocated or distributed as aforesaid, but they can be offset by the company, association or enterprise under ordinary rules.

3. Interest

The taxation of interest has not been changed by the reform.

In general, interest is taxed as ordinary income and is subject to withholding tax at source.

The rate of the withholding depends on whether the payer is a financial institution or not and on whether the recipient is registered with the tax administration or not, namely:

- if the payer is a bank, financial institution or stock exchange agent and the recipient is registered with the tax administration, the rate is 3%;
- if the payer is a bank, financial institution or stock exchange agent and the recipient is not registered with the tax administration, the rate is 7%;
- if the payer is not a bank, financial institution or stock exchange agent and the recipient is registered with the tax administration, the rate is 7% and is applied on the amount exceeding a certain minimum; and
- if the payer is not a bank, financial institution or stock exchange agent and the recipient is not registered with the tax administration, the rate is 25% and is applied on the amount exceeding a certain minimum.

The withholding tax may be credited against the income tax.

The withholding of the tax is not applicable in specified instances (already referred to in III E.2.).

4. Royalties

(a) *Taxable amount*

Royalties paid to individuals (or more precisely to taxpayers not included in the third category) are considered to be second category income and some special rules govern deductions.

When royalties are obtained through the definitive transfer of any kind of assets, 25% of the received sums up to the book value of the asset can be deducted. When royalties are obtained through the temporary transfer of assets, they can be depreciated or depleted according to general rules.

For costs and expenses incurred outside Argentina, a single deduction of 40% of the amount of royalties received is allowed.

Residents who habitually develop research in order to obtain assets which may produce royalties must calculate their income under third category provisions and not under the aforesaid rules.

(b) *Taxation of royalties*

The taxation of royalties was not changed by the reform.

Royalties paid to taxpayers not included in the third category are considered to be second category income and taxed under ordinary rules. This means that they are included in the combined income of the recipient and taxed at progressive rates ranging from 7% to 45%, as shown in Table 1.

Royalty payments exceeding a certain sum are subject to withholding of income tax at source on their gross amount.

The rate of the withholding depends on whether the

recipient is registered with the tax administration or not, namely:
- if the recipient is registered with the tax administration the rate is 7%; and
- if the recipient is not registered with the tax administration the rate is 25%.

5. Service fees

The taxation of service fees was not changed by the reform.

Service fees derived by individuals are taxed as income from independent work under rules discussed in B.7(b) below. This means that they are included in the combined income of the recipient and taxed at progressive rates ranging from 7% to 45%, as shown in Table 1.

Service fees exceeding a certain sum are also subject to withholding of income tax at source.

The rate of the withholding depends on whether the recipient is registered with the tax administration or not:
- if the recipient is registered with the tax administration the rate is 7%; and
- if the recipient is not registered with the tax administration the rate is 25%.

The withholding tax does not apply to payments made to managing partners of limited liability companies, limited companies and companies limited by shares as compensation for their managerial work.

6. Capital gains

(a) *General information*

As stated before, capital gains are subject in Argentina to different tax regimes according to the person, activity and property which is involved. In the case of individuals, capital gains are normally subject to special taxation.

Argentina levies a capital gains tax which was governed until 31 December 1985 by Law 21,284 of 2 April 1976, codified in 1977. As from 1 January 1986, Law 21,284 is revoked and replaced by Law 23,259 published in Official Bulletin of 11 October 1985, which introduced several changes.

Under the new law, individuals and undivided inheritances, whether resident or not, obtaining Argentine-source gains from specified transactions are subject to a capital gains tax which is effective up to 31 December 1995. Entities are in no case subject to this tax and their capital gains are normally taxed as ordinary income.

(b) *Taxable gains*

The capital gains tax is levied on:
- gains derived from the transfer of real property, transfer of the right to acquire the same property (boletos de compraventa), transfer of movable goods, ownership interests or participations in companies, provided such gains are not subject to the ordinary income tax under rules discussed in III E.5(a);
- gains derived from the transfer of documents (títulos), shares and other securities (valores mobiliarios), provided such gains are not subject to the ordinary income tax or are exempt therefrom (i.e. provided such gains are derived by individuals other than commission agents, auctioneers, consignees and other trade agents not specifically included in the fourth category); and
- any gain or capital increase (enriquecimiento) not subject to the ordinary income tax, the tax on games and sporting contests (impuesto a determinados juegos de sorteo y concursos deportivos) or the tax on foreign exchange (Impuesto sobre las Ventas, Compras, Cambio o Permuta de Divisas).

(c) *Exempt gains*

The following are exempt from the capital gains tax:
- gratuitous gains;
- transfers of tangible movable goods acquired by the taxpayer for his personal use or for the use of his family, except for antiques, works of art and luxury investments;
- transfers of documents (títulos), shares, charters (cédulas), bills, bonds and other securities issued or that may be issued by official or mixed entities, in that part corresponding to the national Treasury, provinces or municipalities, provided the exemption is established in a general law or is granted by the Executive Branch;
- transfers of property belonging to foreign ambassadors or consuls or to their personnel or relatives, provided the benefit is established in international agreements or is applicable on the basis of reciprocity. The same applies to property belonging to representatives or agents performing their duties in international bodies of which Argentina is a member; and
- capital gains derived up to a certain sum per year by resident individuals (see (h) below).

(d) *Taxable scope*

The special tax is levied on Argentine-source capital gains only.

Gains are deemed to be Argentine-source if they originate from goods situated, placed or economically utilized in Argentina, or from the performance in Argentina of any act or activity that may produce gains, or from events that occurred in Argentina. The nationality, domicile or residence of the owner of goods or of the parties to the transactions, and the place where contracts are concluded, are immaterial for the aforesaid purposes.

Transfers of funds abroad or from abroad into Argentina are deemed to relate or originate from Argentine-source gains unless the taxpayer can demonstrate the origin of the transfer.

(e) *Computation of taxable gains*

Gains shall be determined by deducting from the price of the transfer, the direct cost and expenses of the transaction, except the capital gains tax itself.

In the computation of taxable gains costs may be updated for inflation; the updatings provided for in the capital gains tax law are made in accordance with a table prepared by the tax administration on the basis of changes in the wholesale price index, general level, supplied by the National Institute of Statistics and Census (Instituto Nacional de Estadística y Censos).

Shareholders that acquire shares from other shareholders and must transfer the shares to the issuing entity by way of redemption shall consider, as the price of the transfer, the face value (valor nominal) of the redeemed shares, as updated in accordance with the table referred to above, between the month of subscription and the month of the redemption.

(f) *Costs*

In general, the cost is established on the basis of the acquisition, construction or production costs, plus improvements made to conserve or increase the value of the relevant goods.

In the case of transfer of immovable property, the following rules are used for the computation of costs:

(i) the acquisition cost, plus expenses necessary to carry out the transaction, or the construction cost plus the cost of land, or the value of the improvements, is updated as from the date of acquisition, conclusion of construction or investment, as the case may be. The value of the construction or improvement is determined by updating each investment between the month in which it was made and the month of conclusion of the construction or improvement; and

(ii) that part of the value established under rules discussed (i) above, corresponding to buildings, constructions or improvements is reduced by a depreciation allowance of 2% per year, computed as from the date of acquisition or conclusion of the construction or improvement, as the case may be.

For immovable property acquired or constructed before 1946, the taxpayer can choose to take as acquisition value, the cadastral value in force on 1 January of such year. In this case, both the 2% depreciation allowance computed on that part of the cadastral value corresponding to buildings or constructions, and the updating referred to in (i), shall be made from January 1946.

The cost of tangible movable property shall be determined by updating the value of acquisition or production, from the month of acquisition or conclusion of production, as the case may be, in accordance with a table prepared by the tax administration on the basis of changes in the wholesale price index, general level. For property acquired before 31 December 1985, the taxpayer can choose to consider the market value as cost. In this case, the cost is updated as from December 1985.

The cost of the documents (títulos), shares and other securities (valores mobiliarios) is determined by updating the acquisition value in accordance with a table prepared by the tax administration on the basis of changes in the wholesale price index, general level, as from the acquisition month. For securities (valores mobiliarios) quoted on stock exchanges (bolsas) or markets, acquired before 31 December 1985, the taxpayer can choose to treat the quotation on such date as acquisition value and 31 December 1985 as the acquisition date. The resulting value is updated in accordance with a table prepared by the tax administration on the basis of changes in the wholesale price index, general level, as from December 1985. No cost is computed for the transfer of shares received as stock dividends as from 1 January 1986. For allocation purposes the f.i.f.o. method is used.

When transferring ownership interests and participations in companies, the difference between the transfer value and the amount of the interest or participation of the transferor partner (socio cedente) shall be treated as taxable gain, as established under the rules of the net worth tax.[2] This includes assets not computed for such tax.

In the case of property acquired by inheritance, legacy or gift, the acquisition value is the value of the property when in the hands of the deceased or donor, under rules established for the income tax at the date of the declaration of the inheritors, declaration of validity of testament or acquisition, as the case may be.

(g) *Losses*

When transactions, acts or activities subject to the capital gains tax result in a loss, the loss can be compensated with other taxable gains derived in the same calendar year. If such losses cannot be offset against other gains as aforesaid, the uncompensated balance can be carried forward for 5 years, to be compensated with other taxable gains, but the compensation with income subject to the ordinary income tax is not permitted.

Nevertheless, losses incurred upon the transfer of shares, ownership interests and participations in companies can be compensated only with gains derived in the same calendar year from the transfer of the same property. If that compensation is not possible, the uncompensated sum can be deducted from net gains derived from the same kind of transactions within the following 5 years. The deduction referred to is not permitted in the case of losses incurred when shares acquired from other shareholders are redeemed by the issuing entity.

Losses that are carried forward to be compensated in future tax years can be updated in accordance with the table prepared by the tax administration on the basis of changes in the wholesale price index, general level.

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2. For further information on the net worth tax, see 6.01 in the Argentine chapter of *Corporate Taxation in Latin America*.

(h) *Personal allowance*

Resident taxpayers can deduct from their net gain, a minimum exempt allowance of 1,500 australes per year, as adjusted in accordance with the table prepared by the tax administration on the basis of changes in the wholesale price index, general level.

For the aforesaid purposes, there shall be considered as residents of Argentina, those individuals that live in Argentina for more than 6 months in the calendar year (año fiscal), and those who are abroad rendering services to the national government, provinces or municipalities, or working in international bodies of which Argentina is a member.

(i) *Computation and payment of the tax*

The annual taxable net capital gain is taxed at a 15% rate.

If the computation of gains subject to the capital gains tax includes gains derived from transfers subject to the tax on the transfer of securities, the tax paid on the transfer of securities is creditable against the capital gains tax up to a limit of 15% of the gain derived from the taxable securities.

(j) *Roll-over for the taxpayer's house*

When a taxpayer sells his only dwelling house in order to acquire or construct another one for the same purpose, the taxpayer can choose to pay the tax resulting from the sale or deduct the gain from the cost of the new property, under regulations to the law. This election can also be made when the taxpayer transfers his only dwelling house and/or land for the construction of an apartment building, provided the taxpayer receives, for the transfer, up to a maximum of one dwelling unit in the new apartment building.

The option shall be made at the documentation of the sale. Within 1 year from such documentation, the taxpayer shall prove the acquisition of the new property and its destination for his own dwelling.

Notaries, auctioneers, brokers, commission agents, other intermediaries and the buyer are required to withhold the capital gains tax at source or to act as reporting agents.

(k) *Transfers subject to the tax on transfers of securities*

Transfers of shares, bonds, debentures and other securities located in Argentina are subject to the tax on transfers of securities.

Transfers for a consideration of shares and participations in limited liability companies, limited partnerships and partnerships limited by shares, for that part belonging to the paid-in capital, are also subject to the same tax on transfers of securities.

For the purposes of the tax, the following assets are deemed to be located in Argentina:
- the securities issued by the Central Government, provinces and municipalities; and
- shares, debentures and other securities issued by companies established in Argentina.

Law 21,280 of 25 October 1977 exempts the transfer of Bills of the National Treasury as well as swap operations, stock exchange guarantees, and other transactions not involving a final transfer of ownership.

Decree 649 of 13 July 1981 published on 16 July 1981 exempts from the tax on security transfers:
- the distribution of stock dividends;
- securities distributed as a consequence of the capitalization of the appreciation resulting from a revaluation;
- transfers which are a direct consequence of a company reorganization; and
- transactions representing the original placement of a security.

After the tax reform of 1985, the tax on transfers of securities is calculated at a 0.75% rate, applied to the value of the transaction.

The tax referred to herein is creditable within certain limits against the liability to the income tax or to the capital gains tax.

7. Income from work

(a) *Employment income*

Employment income is included in the individual's total income and taxed under rules discussed in IV A. above.

A withholding tax is levied on monthly salaries. Brackets are adjusted for inflation every month.

The following allowances can be taken in computing employment income (amounts in australes for January 1986):

– basic personal allowances (ganancia no imponible)	168
– spouse	84
– dependent ascendant, descendant, brother or sister	42
– funeral expenses incurred in Argentina by the taxpayer or his dependents, up to	34
– life insurance premiums, up to	34
– deduction from earned income	210

The rates of the withholding tax are shown in Table 2.

(b) *Income from independent work*

Income from independent personal services is included in the individual's total income and taxed under rules discussed in IV A.

Income from independent work is also subject to the withholding of income tax at source.

The rate of the withholding depends on whether the recipient is registered with the tax administration or not:
- if the recipient is registered with the tax administration the rate is 7%; and

Table 2

Withholding tax on salaries (January 1986)

Taxable base (in australes)		Fixed amount + percentage on excess	
——	42,815	——	7
42,815	100,740	2,995	8
100,740	157,825	7,630	9
157,825	230,025	12,770	10
230,025	316,490	19,990	11
316,490	431,505	29,500	12
431,505	546,515	43,300	13
546,515	719,450	58,250	15
719,450	935,205	84,190	17
935,205	1,150,955	120,870	19
1,150,955	1,366,705	161,865	21
1,366,705	1,654,655	207,175	23
1,654,655	2,013,960	273,405	26
2,013,960	2 374,195	366,325	29
2,374,195	2,733,410	471,265	32
2,733,410	3,164,915	586,245	35
3,164,915	3,596,420	737,270	38
3,596,420	4,315,870	901,240	41
4,315,870	——	1,196,215	45

- if the recipient is not registered with the tax administration the rate is 25%.

(c) *Directors' fees*

Directors' fees are included in the individual's total income and taxed under rules discussed in IV A.

Fees paid to resident directors are subject to a 7% withholding tax which is creditable against the final liability of the recipient.

V. TAXATION OF NON-RESIDENTS

A. General description

1. Concept of non-resident

Argentine law does not provide a general concept of "non-resident" companies or individuals for tax or corporate law purposes.

For the purposes of withholding taxes, however, there shall be considered as non-residents those who receive their income abroad either directly or through attorneys (apoderados), agents, representatives or any other commissioner (mandatario) in Argentina, and those who receive their income in Argentina, but do not prove permanent residency in the country.

2. General rules for non-residents

Net income from Argentine sources paid to non-resident corporations, companies, enterprises and individuals is subject to a 45% withholding tax which is final. This tax is not applicable to dividends and similar income for which there are special rules (to be dealt with below).

The 1985 tax reform provides that, for withholding purposes, net income from Argentine sources is normally presumed to be a percentage of gross payments, which percentage is generally different from that provided for by the old legislation.

Thus, net income derived by non-residents from Argentine sources is presumed to be a percentage of the gross considerations paid for the leasing of movable property, foreign loans, licensing of patents, exploitation of copyrights, technical assistance, letting of real property and remuneration paid to intellectuals, technicians, professionals and artists (see V. D. below).

Argentine-source net income is also presumed to be, with right to rebuttal, 50% of the consideration for the transfer of goods situated, located or economically used in Argentina, but belonging to enterprises or companies organized, established or located abroad. In this case the taxpayer can choose to be taxed on actual net income and deduct from gross income expenses incurred in Argentina which are necessary to obtain, maintain or conserve the income and other deductions authorized by the law under ordinary rules.

In the case of unspecified income, Argentine-source net income is presumed to be, without right to rebuttal, 80% of gross payments. Therefore, as only 80% of the amount of unspecified income paid to non-residents is taxable at the 45%, the effective total rate is 36% of gross receipts.

Note, however, that, in the case of dividends, profits of permanent establishments and profits of unincorporated entities deemed to be distributed to non-residents, the withholding tax is levied on the entire dividend or profit.

Under General Resolution of the tax administration 2,529 of 12 March 1985, published in the Official Bulletin of 14 March 1985, if the income tax is sustained by the payer, the taxable income must be grossed up with the tax. This grossing up does not apply to interest paid on foreign financing destined for industry, mining and the extraction of natural resources.

3. Taxation of excess profits

A special tax (which was not changed by the tax reform) is levied on after tax income (and repatriable capital gains derived from the disposal of the investment) exceeding in a year 12% of the registered foreign investments as follows:
- on profits between 12 and 15% the tax is 15%;
- on profits between 15 and 20% the tax is 20%; and
- on profits above 20% the tax is 25%.

An excess of profits (or capital gains) in one year may be set off against profits of less then 12% of registered foreign investment capital in the 5 previous years. Registered capital is defined as investments and reinvestments registered at the end of the taxable period preceding payment, less repatriations previously made. Where capital gains are derived from the disposal of part of the registered capital, only the corresponding proportional part thereof is taken for computation of the tax.

Some profits are not taxed, i.e. profits arising from unregistered investments; profits from unregistered temporary investments; and profits not exceeding 12% of registered capital. An exemption from the tax is granted to: profits reinvested in Argentina, either in the same or another enterprise; profits paid to foreign controlled local enterprises; and profits paid in stock dividends.

Where the tax is levied on after-tax profits, it is due once the profits are paid in cash or in kind, or once they are at the disposal of the beneficiary and disposed of with his explicit or tacit acceptance, provided, in so doing, the funds are taken from the business from which they arise. Where the tax is levied on capital gains, the tax is due when they are remitted abroad.

The tax is normally withheld at source.

The executive branch is vested with the power to enact general rules introducing exemptions or amendments to the tax threshold and rates for activities having special characteristics, involving high risks or governed by special regimes.

B. Taxation of subsidiaries

Local subsidiaries of non-resident companies are subject to income tax under ordinary rules. This means that, in general, there is no difference between the taxation applicable to an Argentine company and that applicable to a subsidiary of a foreign company. Both are subject to the same rules.

Argentine legislation, however, contains specific provisions relating to interest and technical assistance fees.

Interest on loans paid by a foreign controlled local enterprise to a non-resident controlling entity or person is deductible as far as the contract under which it is paid is in accordance with normal market practices between independent entities and with provisions of the Foreign Investment Law. Loan contracts are deemed to comply with such conditions when the Central Bank of the Argentine Republic has raised no objection on the grounds of the specific contractual conditions or of the inadequate level of indebtedness of the subsidiary.

Interest paid by a local subsidiary on a loan received from a foreign company (either related or unrelated) is subject to a final withholding tax of 45%, as calculated on 35% of the gross amount, giving an effective rate of 15.75%, provided the loan is made at arm's length and there is no objection by the Central Bank within 30 days from notice of the conditions of the loan, either because of the specific conditions of the transaction or the excessive level of indebtedness of the borrower. If there is an objection to the loan, the gross amount of the interest is subject to a 45% withholding tax which is final.

Fees and other remuneration paid to either related or unrelated companies for technical assistance from abroad will be deductible provided they do not exceed:

- 3% of the sales or receipts established as the payment in the contract;
- 5% of the amount of the investment actually made on the basis of technical assistance.

In the particular case of related companies, the law establishes that contracts having as their principal or secondary objective the transfer of technology or trademarks from abroad to persons domiciled in Argentina, concluded between a foreign controlled local enterprise and the company abroad which directly or indirectly controls it, or a subsidiary of the latter, must be submitted to the National Institute of Industrial Technology (INTI) for prior approval. If the contract is so approved, remunerations are subject to a 45% withholding tax, as calculated on a percentage of payments, which percentage is 80% in the case of patents or trademarks (36% effective rate) and 60% in the case of technical assistance (27% effective rate). If the contract is not so approved, payments are disallowed as a deduction and are subject to a 45% withholding tax on gross amounts.

The taxation of dividends paid by the subsidiary varies depending on whether the recipient identifies himself upon collection of the dividend or not.

Dividends paid by corporations and by partnerships limited by shares to non-residents who identify themselves upon collection of the dividends, or to permanent establishments belonging to entities organized abroad or to non-resident individuals, are subject, in addition to the 33% corporate tax, to a 17.5% withholding tax. The combined rate amounts to 44.725%.

Dividends paid by corporations and by partnerships limited by shares to non-residents who do not identify themselves upon collection of the dividend are subject, in addition to the 33% corporate tax, to a final withholding tax at a 22.50% rate. The combined rate amounts to 48.075%.

Dividends in cash or in kind are taxable irrespective of the company funds out of which they are paid (e.g. reserves irrespective of their establishment, foreign source income, capital gains, exempt income and so on).

Income exceeding, in a year, 12% of registered foreign investment may be subject to the excess profits tax discussed in V A.3.

C. Taxation of branches

(a) *Taxable base*

Argentina adopts the source principle for the allocation of income and the income tax law does not provide for a definition of permanent establishment.

Establishments and branch offices must keep records separate from their head office, and must determine their own net profits under ordinary rules. A reasonable allocation of head office expenses related to worldwide operations may be deducted in computing the taxable profits of the branch.

If separate records are not kept as aforesaid, the tax authorities may consider that the branch office and the head office form one economic unit, and may then estimate the amount of net taxable profits on the basis of average ratios of profits which are obtained by independent enterprises engaged in the same or similar activities.

(b) *Taxation of profits*

The taxation of branch profits was not changed by the reform.

Whether or not remitted to the head office or to any other corporation or individual outside Argentina, profits of branches and other permanent establishments are subject to profits tax at an effective rate of 45%. The rate set for branches is slightly higher than the combined rate normally applied to local subsidiaries of foreign firms (44.725%).

Income exceeding, in a year, 12% of registered foreign investment may be subject to the excess profits tax discussed in V A.3.

In general, most foreign investors operating a business of any substance in Argentina prefer to set up a subsidiary rather than a branch. The principal reason investors generally prefer to set up a subsidiary is because in that way they limit their responsibility to the subsidiary's assets without further involvement of the parent company. Moreover, after tax company profits are subject to a 17.5% dividend tax when distributed to non-resident investors that identify themselves upon collection of the dividend, but are not subject thereto if they are reinvested in the company; branch profits, however, are subject to a 45% tax which is applicable even when reinvested.

D. Taxation of particular items of income

1. Dividends

(a) *Dividends in general*

The taxation of dividends varies depending on whether the recipient identifies himself upon collection of the dividend or not.

Dividends paid by corporations and by partnerships limited by shares to non-residents who identify themselves upon collection of the dividend, or to permanent establishments belonging to entities organized abroad or belonging to non-resident individuals, are subject to a 17.5% withholding tax.

Dividends paid by corporations and by partnerships limited by shares to non-residents who do not identify themselves upon collection of the dividend are subject to a final withholding tax, at a 22.50% rate.

Dividends in cash or in kind are taxable irrespective of the company funds out of which they are paid (e.g. reserves irrespective of their establishment, foreign source income, capital gains, exempt income and so on).

(b) *Profits of unincorporated entities (entities other than stock corporations)*

Profits derived by sole proprietorships, general partnerships, limited partnerships and limited liability companies are deemed to be entirely allocated to the owner or distributed among partners or members. In the case of partnerships limited by shares, the profits are deemed to be distributed in accordance with the percentage of the interest in the partnership's capital belonging to each general partner (socios comanditados).

If the profits referred to are distributed or are deemed to be distributed to non-residents they are subject to income tax at a 45% rate withheld at source (this rate consolidates both the corporate and the dividend tax).

(c) *Stock dividends*

The taxation of stock dividends also varies depending on whether the recipient identifies himself upon collection of the dividend or not.

Stock dividends distributed to persons who identify themselves upon collection of the dividends are exempt from income tax.

Stock dividends paid to persons who do not identify themselves upon collection of the dividend are subject to a 22.5% withholding tax which is final.

(d) *Excess profits*

Income exceeding, in a year, 12% of registered foreign investment may be subject to the excess profits tax discussed in V A.3.

2. Interest

Interest payments to non-residents are subject to a 45% tax rate withheld at source.

In accordance with the 1985 tax reform, Argentine-source net income is presumed to be, without right to rebuttal, 35% of interest on foreign loans of any origin or nature. Therefore, as only 35% of the amount of interest paid to non-residents is taxable at the 45% rate, the effective total tax rate is 15.75%.

Interest paid on foreign loans made after 5 January 1977, for the purpose of financing imported fixed assets subject to depreciation is tax exempt. Interest may also be exempt in other instances, as referred to in II B.3.

3. Royalties

Royalty payments to non-residents are subject to a 45% tax withheld at source.

In accordance with the 1985 tax reform, Argentine-source net income from the licensing of patents and trademarks is presumed to be, without right to rebuttal, 80% of payments to non-residents. The percentage is 100% if requirements of the Law on Transfer of Technology are not complied with. Therefore, if requirement of such Law are complied with, as only 80% of the amount of patent royalties paid to non-residents is taxable at the 45% rate, the effective total rate is 36%.

Under the same tax reform, Argentine-source net income derived from the exploitation of copyrights in Argentina is presumed to be, without right to rebuttal, 35% of payments to non-residents, provided the copyrights are duly registered with the National Copyright Bureau, the payment is made to the author or his heirs, and some other conditions are met. Therefore, in this case, as only 35% of the amount of royalties paid to non-residents is taxable at the 45% rate, the effective total rate is 15.75%.

In the case of foreign motion pictures only 50% of the price, consideration or royalty paid to producers or distributors is taxed as income from an Argentine source. Therefore, as only 50% of the amount paid to non-residents is taxable at the 45% rate, the effective tax rate is 22.5%.

4. Service fees

(a) *Technical and financial assistance fees*

Fees and other remuneration derived from technical, financial and other assistance provided from abroad which is used in Argentina is deemed to be Argentine-source income.

In accordance with the 1985 tax reform, Argentine-source net income is presumed to be, without right to rebuttal, 60% of payments for technical assistance, engineering or consulting services that, in the opinion of the competent authority, cannot be obtained in Argentina, provided they are duly registered and have been actually rendered. The percentage is 100% if there is a failure to comply with the requirements of the Law on Transfer of Technology. Therefore, as only 60% of the amount of technical or financial assistance fees paid to non-residents is taxable at the 45% rate, when there is compliance with the requirements of the Law on Transfer of Technology, the effective total rate is, in that case, 27%.

(b) *Payments to members of boards of directors*

Payments to non-resident members of the boards of directors of Argentine-based enterprises are subject to 45% withholding tax.

Argentina source net income is presumed to be 70% of fees and other remuneration paid to non-residents rendering services temporarily in Argentina for a period not exceeding 6 months in the calendar year (año fiscal).

5. Capital gains

Capital gains are subject to different tax regimes depending on the person, activity and property which is involved.

If capital gains mentioned in III E.5(a) are derived by non-residents, the gains are subject to income tax at a 45% rate. If taxable income includes income from transfers subject to the tax on transfers of shares, such a tax can be credited against the income tax up to a limit which, in the case of non-residents, is 15%.

Capital gains mentioned in IV B.6. are subject to the special taxation discussed therein even if derived by non-residents. Note, however, that gains obtained by non-residents are subject to the capital gains tax only if it can be clearly proved to the satisfaction of the tax administration that the gain belongs to individuals or undivided inheritances.

Transfers mentioned in IV B.6(k) are subject to the tax discussed therein, even if derived by non-residents.

6. Transportation payments

As stated before, net income from Argentine sources paid to non-residents is subject, under general rules, to a 45% final withholding tax.

Companies not established in Argentina and engaged in transportation between Argentina and foreign countries are presumed to derive from the aforesaid activity a net income from Argentine sources equal to 10% of gross receipts from fares and freights. The assumption referred to does not cover the gains derived from the sale of immovable property occupied by a branch of the foreign enterprise.

Likewise 10% of sums that enterprises established or organized in Argentina pay to foreign shipping companies for time or trip freight (fletamentos a tiempo o por viaje) is presumed to be Argentine-source net income.

These assumptions cannot be rebutted, but do not apply when the transportation enterprise is established in a country with which Argentina has entered into a treaty establishing an exemption for the aforesaid income.

Companies not established in Argentina carrying on business with containers used for transportation in Argentina, or from Argentina to foreign countries, are presumed, without the right to rebuttal, to derive from the aforesaid activity a net income from Argentine sources equal to 20% of gross receipts derived from the same.

Agents or representatives in Argentina of the companies referred to above are jointly and severally liable for the payment of taxes.

7. Leasing payments

Net income from Argentine sources paid to non-residents is subject, under general rules, to a 45% final withholding tax.

Argentine-source net income is presumed to be, without right to rebuttal, 40% of sums paid for the leasing of movable property. Therefore, as only 40% of the amount of leasing paid to non-residents is taxable at the 45% rate, the effective total rate is 18%.

8. Expatriates working in Argentina

Net income from Argentine sources paid to non-residents is subject, under general rules, to a 45% final withholding tax.

Argentine-source net income derived by non-residents is presumed to be, without right to rebuttal:
- 35% of sums paid to non-resident artists hired by the National Government, provinces, municipalities or charities in order to perform in Argentina for up to 2 months. Therefore, in this case, as only 35% of the gross amount paid to non-residents is taxable at the 45% rate, the effective total rate is 15.75%; and
- 70% of wages, fees and other remuneration paid to other persons rendering personal services (e.g. intellectuals, technicians, professionals, artists not referred to above, athletes, etc.) working temporarily in Argentina for a period not exceeding 6 months in the calendar year (año fiscal). Therefore, in this case, as only 70% of the gross amount paid to non-residents is taxable at the 45% rate, the effective total rate is 31.50%.

VI. FINAL REMARKS

The recent Argentine tax reform touches practically all the main tax laws and covers many different aspects that may appear to have no connection with each other.

As regards income taxation, the final text of the reform does not include all the changes proposed by the Executive Branch; nevertheless, the amount of the tax is increased through measures such as changes in the allocation of income and valuation of assets, reduction of exemptions and allowances, taxation of some dividends previously exempt, and more stringent rules concerning the deduction of losses.

The possibility, previously granted to third category taxpayers, of using the cash method for the allocation of income is eliminated, thus anticipating taxation.

The new valuation rules give more importance to values at the end of the period and involve, therefore, an augmentation in the amount of inventories, but at the same time increase the cost of sales.

The reform introduces more stringent rules on the deduction of losses and reduces the carryover term from 10 to 5 years. This measure may result in a serious restriction for those taxpayers enjoying benefits from preferential or promotion regimes that permit the deduction or accelerated depreciation of investments.

In the case of non-residents, the system of presuming net Argentine-source income as a percentage of gross payments is amended to include items of income not previously covered and to increase some of the percentages.

Dividends which were exempt when paid to residents that identified themselves upon collection are now taxed (except for stock dividends). Some measures, however, are taken to avoid double taxation: intercompany dividends continue to be exempt and, in the case of dividends paid to resident individuals, a credit is granted for the tax paid when in the company's hands.

Also avoided is the economic double taxation of limited liability companies. Under the old legislation, income obtained by limited liability companies was taxed both in the company's hands and in the hands of partners without any measure to eliminate or alleviate the economic double taxation. After the reform, the income of such companies is taxed in the member's hands only, in line with the treatment given to general partnerships.

The adjustment of income for inflation introduced in 1978 had been criticized on the grounds that it was static, i.e. calculated on net worth at the end of the tax year, preceding that which is being corrected without consideration to changes during the tax year. It resulted in a lack of protection for capital contributions whose real value would diminish during the year and it would also – for the same reason – encourage the withdrawal of profits. This is now corrected by the new legislation by considering changes during the tax year.

Another criticism related to the partial nature of the adjustment (only some assets are covered), is still valid after the reform of 1985, because there is no substantial – only secondary – improvement in the coverage of the adjustment, e.g. by including real property representing goods for sale.

THE NETHERLANDS:

A Step Towards Simplicity*

1. POINTS OF DEPARTURE

Income tax too complicated

The "queen of taxes", our income tax, has been seriously ill for some time now. Over the past few years a procession of physicians has filed past her sickbed. They all agree on the syndrome: she is suffering from excessive complexity. Some even go so far as to declare the income tax dead; they plead for a worthy successor to the throne in the form of an expenditure tax. Others still detect signs of life. But opinions differ on the best type of cure.

Not only in the Netherlands is income tax affected by the disease of excessive complexity. In many countries the income tax is bedridden, and attempts are being made to get the patient back on her feet again. The lessons which we can draw from this to remedy the situation in our own country are, however, of limited significance. The medical history of the patients differs too greatly for a useful comparison. International criticism of the income tax does confirm the diagnosis that it is a serious ailment. When only a small minority of people are able to fill in their tax return without help, there is something fundamentally wrong.

Formation of a Tax Reform Commission

This complexity has led to the formation of a Commission for the simplification of wage withholding and income tax. Instituted in September 1985 by the Minister of Finance, the Commission was given the task of presenting a broad outline of its proposals before the end of May 1986.

No "Grand Design"

The Commission assumes the viability of the income tax. The assignment permitted no other assumption. For that reason, and in view of the limited time granted, the Commission does not present a comprehensive plan (a "grand design"). Nor has the concept of taxable income been analysed in depth. A reasonable analysis of this complex concept calls for a broader study over a longer period than the Commission has been granted. However, the report does contain a cohesive package of practical, and in some respects fundamental and far-reaching, proposals for simplification which can be achieved in a relatively short time.

High rates unavoidable

A major reason for the complexity of our taxes is the level of the rates: the higher the rates, the greater the need to account for special personal circumstances. It is an illusion to think that this problem can be materially alleviated by means of a simplification operation alone, however drastic it may be. The heavy burden of taxes and social security contributions is a direct and inseparable consequence of high government spending and an extensive social security system. When the public sector siphons off approximately two thirds of the national income, as is the case at present in the Netherlands, taxes and contributions must be high. Simplification as such can do little to alter this.

Restriction of deductions offers little solace

In particular, it is an illusion to think that a restriction of tax deductions would permit a substantial reduction of the burden of taxes and contributions. Many deductions are strongly felt to be socially justified or are so closely linked to earning income that abolition or a major cut would not be a realistic proposal. The reduction of deductions which are used as an alternative to direct subsidies from the treasury (tax expenditures) does simplify taxes, but in itself offers no room for a reduction in rates. The subsidies concerned must then be channeled directly through the budget.

Proposals revenue neutral

The Commission felt it useful and necessary to preface its principal proposals by a warning against inflated expectations. It had to work in the context of revenue neutrality; taken together, the proposals were not allowed to produce any appreciable sacrifices from the treasury and the social security funds.

Four objectives

The four central objectives of the Commission are:

(1) One fixed rate over a large range of income.
(2) Combining of income tax with general social security contributions (hereafter, contributions).
(3) Wage tax, a final levy as far as possible.
(4) Streamlining of deductions and other schemes.

No major income consequences

The Commission imposed an important restriction on itself for the development of its proposals. It looked for possibilities of simplification which would not cause any great, abrupt shifts in personal income distribution. Where such shifts did threaten to occur, it designed compensatory measures which would harm the simplification as little as possible. On the other hand, simplification is impossible if it is required in advance that *no one* experiences a positive or negative effect on disposable income. This restriction would block practically any change in the existing tax system.

The changes in income arising from the proposals remain within reasonable limits (see Sec. 7), certainly when they are compared to the continuous changes in society and the consequences thereof on a family's disposable income. For example, shifts in the labour market (finding another job, becoming unemployed) or changes in personal circumstances (purchase of a house, growth of the family). It should be remembered that, through the many shifting processes in our economy, the consequences of changes in the tax burden are generally fully or partially compensated in the long run.

Limits for the Commission

The limits which the Commission had to observe were strict: a tight timeframe, no negative balance from the proposals for the treasury or for the social security funds, and narrow margins for permissible income shifts. The Commission feels that it can present a substantial simplification of our taxation and social security contributions system within these limits. A full de-

* This brochure is available upon request at the Information Service of the Ministry of Finance (070-76 77 67).
The entire report is available upon payment in advance of Dfl. 35 per copy to account number 51.88.27.666 at ABN Bank or to account number 751 at the National Giro in name of Distributiecentrum Overheidspublicaties (address: P.O. Box 20014, 2500 EA The Hague) under listing of ISBN 90 346 0841 7.
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scription and justification of the proposals can be found in the Commission's report and the accompanying letter presented to the Minister of Finance on 27 May 1986.

Report is unanimous; it is the final report

Two points from the accompanying letter merit special mention. First, the Report has the approval of all members of the Commission. Secondly, it is submitted as a final report, even though the assignment provided for the Commission to continue to the end of this year. The translation of the Commission's proposals in terms of laws, regulations, and procedures was not within its mandate. A non-governmental commission is less qualified to handle such technical matters. The accompanying letter therefore ends with the following statement:

"The Commission considers its Report completed to the extent that a meaningful public discussion of the proposals need not wait for further detailed recommendations. The Commission has therefore completed its main task and requests that it be released from its assignment."

2. COMBINATION OF INCOME TAX AND CONTRIBUTIONS

Array of levies complicated

Practically everyone who pays wage and/or income tax is also liable for contributions, with the exception of the aged. Both types of public levies depend on income, but in different ways. Wage and income tax are levied according to a progressive graduated scale with a complicated system of standard exemptions and personal allowances. The contributions rise in proportion to income up to a contribution ceiling, with special relief provisions for people with the lowest incomes (in particular the self-employed). This complex array of provisions is a source of irritation and confusion to taxpayers.

Combining of taxes and contributions

The Commission proposes combining taxes and contributions into one levy on the same base, while ensuring that the identity and the particular purpose of each part is maintained.

Deductibility of contributions absorbed

In the current system, contributions are deductible for wage and income tax purposes. This is not really possible in the case of a combined levy, or is at least no longer meaningful. The current deductibility of contributions is therefore "absorbed" into a lower rate of the combined levy in such a way that the sum of the tax part and the contribution part constitutes the new combined *income levy*. In practice this does not affect the position of tax and contribution payers.

Advantages of combining taxes and contributions

Combining taxes and contributions has a series of practical advantages: by far the largest single deduction is eliminated, separate returns, refunds, assessments and appeal procedures for levying contributions are no longer needed. Moreover, there is a major gain as a result of the increased clarity of the proposed system. Precisely because the contributions are no longer deductible, but still remain visible as a readily identifiable part of the combined levy, the taxpayer can see without complicated calculations, how much he or she is paying for each.

Flat rate over large range of income

An even more important advantage arising from combining taxes and contributions is that taxes and contributions together are an almost constant percentage of income, up to a certain income level. This makes it possible to have a combined rate system which has a flat rate over a large range of income above the standard deduction (discussed below in greater detail).

Table 1 illustrates the simplified rate. Such a system opens the door for a large number of simplifications, i.e. in all those cases where provisions are complicated as a consequence of the existing progression in the tax rate.

Complication in the field of contributions

There is, however, a complication. People receiving a wage or social security benefit currently pay only contributions towards two of the five general social insurances, namely the old age pension (AOW) and the widow and orphan pension (AWW). The other three contributions [the "supplementary contributions" for special medical benefits (AWBZ), child allowances (AKW), and disability benefits (AAW)] are paid by the employer or the benefit-paying institution. Economically and financially, it makes no difference, of course, whether the employer pays a wage from which he deducts two contributions at source, while he pays the other three directly – which is the current situation – or whether he pays a higher gross wage and withholds all five contributions. The payroll costs for the employer and the net income of the employee are the same in both cases.

Transfer of supplementary contributions

As it is preferable from the point of view of simplification to treat the five general social insurances in the same way, the Commission proposes to transfer the payment of "supplementary contributions" from the employer to the employee, and from the benefit-paying institution to the benefit-receiving party. Employees and those receiving benefits are thus placed in the same position as the self-employed, as the latter already pay their own contributions for all five general social insurances.

Compensatory increase in wages and benefits

In order to ensure that nobody suffers a decline in his or her disposable income through the transfer of contributions, gross salaries and benefits must be increased by the amount of the supplementary contributions (grossing up). Although large sums are concerned (Dfl. 20,700 million or 5% of GNP in 1985), the transfer of the con-

Table 1. Rate scale options presented

Four-bracket scale:
Standard deduction: Dfl. 4,250 — *(Amounts in guilders)*

Levy percentage	*Bracket length*	*End of bracket at*
40	45,000	49,250
55	35,000	84,250
65	40,000	124,250
70		

Three-bracket scale:
Standard deduction: Dfl. 4,250 — *(Amounts in guilders)*

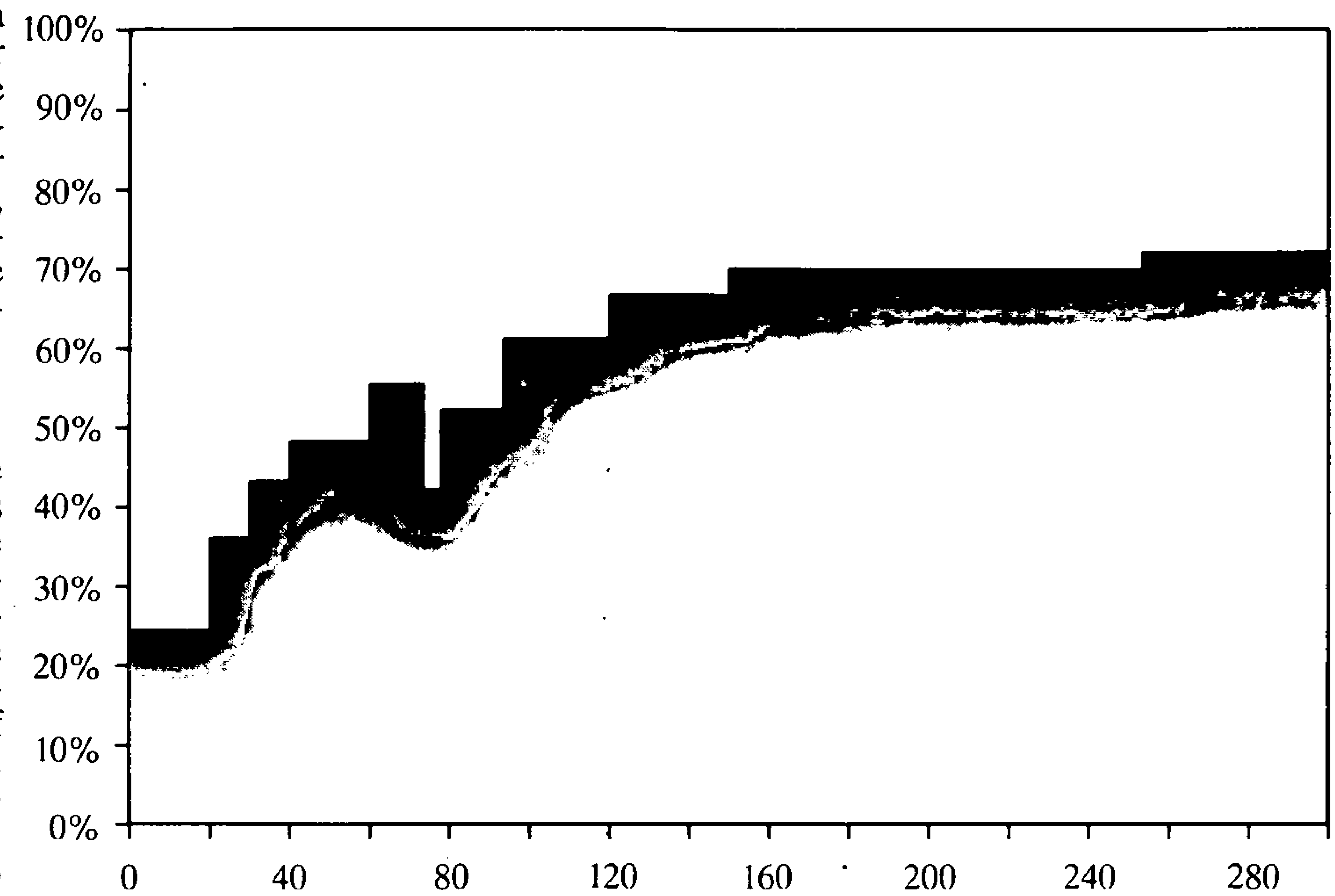
Levy percentage	*Bracket length*	*End of bracket at*
40	45,000	49,250
55	35,000	84,250
65		

tribution obligation and the grossing up of salaries and benefits is essentially a paper operation: nobody is better or worse off because of it. However, the system of public levies – taxes and contributions together – becomes simpler and clearer, while the desired flat rate, applicable to as many people as possible, can be achieved only after the transfer of the supplementary contributions.

Adjustment of pension schemes

The operation requires administrative and technical adjustments of salaries and benefits and of schemes which are linked to gross salary (for example, private pension schemes). These problems can be solved. Nevertheless, the Report indicates a solution for temporarily avoiding the formal step of grossing up, without interfering with the introduction of the simplified income levy. For purposes of this Report, it is assumed that this interim step is either unnecessary or has already been carried out.

Figure 1. Rate 1985 a)



a) Single income families

Position of the aged and non-residents

Finally, we must consider the special position of two groups: the aged and non-residents. Their position requires special attention because they are currently not subject to the same method of taxation and/or contribution as other taxpayers. The proposed change in the system could result in a substantial impact on their income. These problems and the proposed solution are discussed in Sec. 3.

3. THE INCOME LEVY

Income levy ...

The transfer of supplementary contributions and the "absorption" of the deductibility of contributions clears the way for producing one simple rate for tax and contributions together: the *income levy*. The system permits a relatively low standard deduction which is applied both to taxes and contributions. At present, contributions are imposed as of the first guilder of income.

... with one standard deduction

This individual *standard deduction* amounts to Dfl. 4,250 per annum. The amount is midway between the current standard income tax exemption and the absence of an exemption in the general social security system.

... and a rate scale with only a few brackets

The proposed rate scale has far fewer brackets than the existing one, which consists of nine brackets. The Commission presents two options (see Table 1). One is a scale with four brackets, on which successive percentages of 40, 55, 65 and 70 are levied. In addition, the Commission presents an even simpler scale which has only three brackets: the top bracket of 70% is eliminated in this option.

Fig. 1 depicts the present rate scales, fig. 2 the two scales which are presented by the Commission. In the case of fig. 2, it must be remembered that the income on which the rate is levied is not the current taxable income, but the grossed up income.

Comparison of tax burden

A comparison of the current and the proposed scales is difficult. In most cases levy percentages cannot be directly compared with current tax and contribution rates, since they are totally different things: the income levy combines taxes and contributions; it is levied on the grossed up income; it does not allow deduction of contributions and it has a completely different standard exemption. That is why in fig. 3 the current and the proposed scales are brought together in a way which makes comparison possible on the basis of current taxable income. The graph shows how the grossed up income is related to the current taxable income. After deduction of the income levy, we have a "net" income. This can be compared to a corresponding "net" income (the black curve) under the current tax and contribution system. It is clear from the graph that the two "net" income curves differ only slightly.

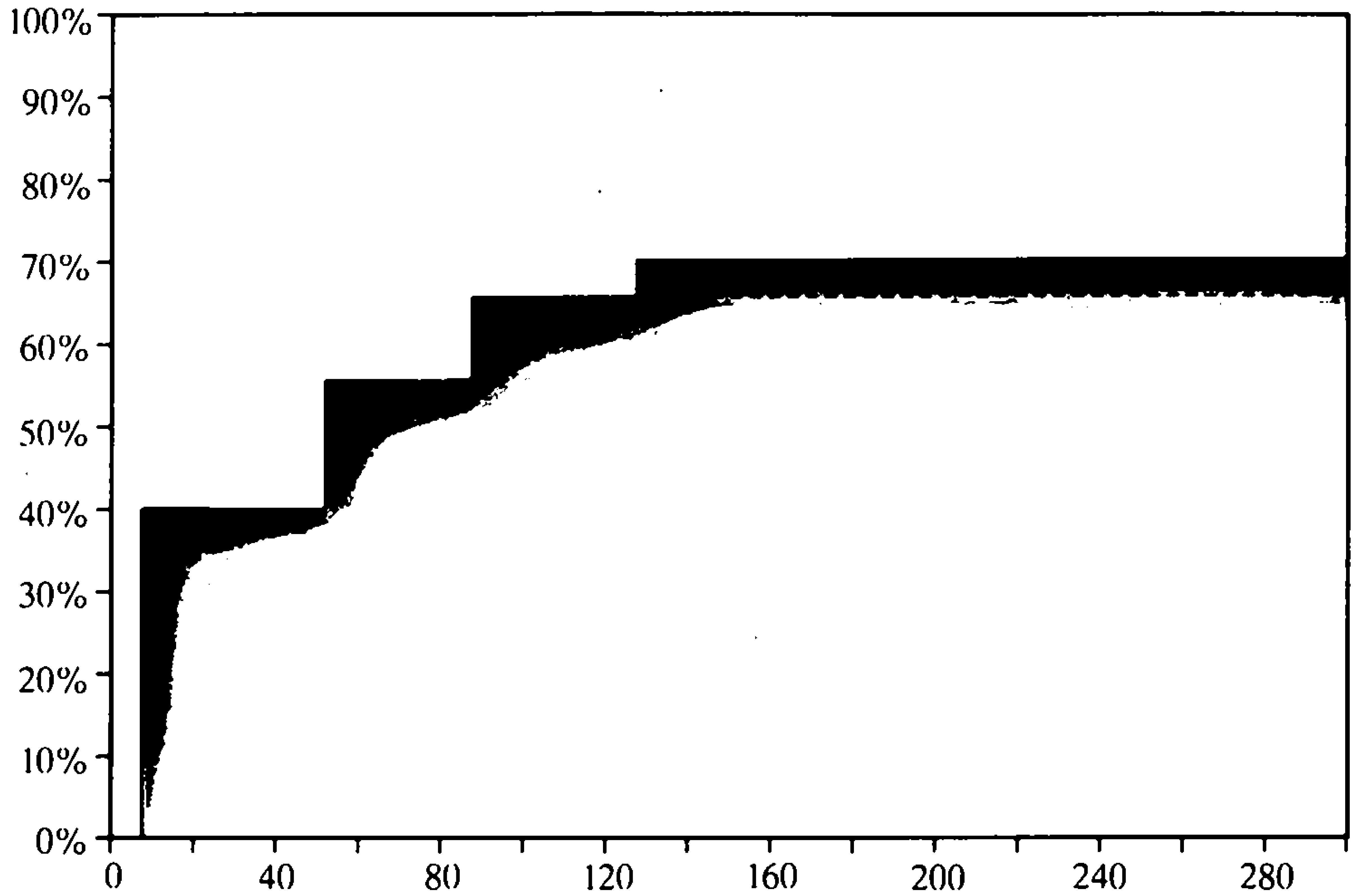
Consequences for income illustrated

The significance of the operation for family income can be illustrated by means of *microeconomic simulations*: these show the difference in net disposable income before and after the proposed changes. Some figures are given in Sec. 7; for more detailed data on the consequences for income refer to the Report. It can be seen from the simulation results in the Report for different income groups and different types of households that the income changes remain within fairly narrow limits.

Large first bracket including contribution part

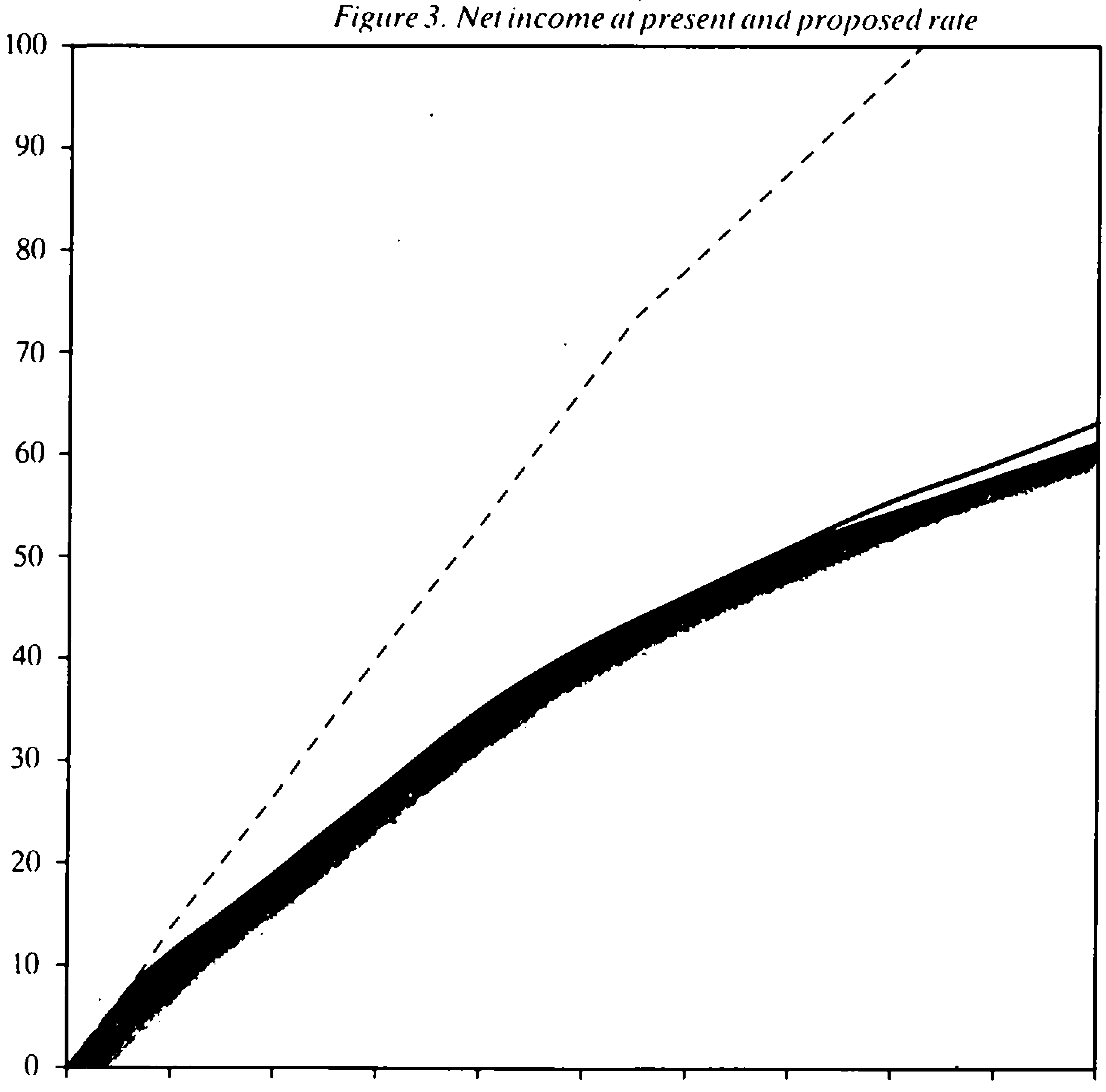
The contributions for the five general social insurances are fully incorporated in the first bracket of the scale. The higher brackets consist only of tax. The maximum income liable to contributions is the same as the income corresponding to the end of the first bracket plus the standard exemption (Dfl. 49,250). The rate of the first bracket (40%) consists of 30% contributions and 10% tax. These percentages are calculated in such a way that the revenue from the contribution part, on the basis of the situation in 1985, is equal to the revenue from the separately levied present contributions.

Figure 2. Proposed rate a)



a) With double standard deduction ——— four-bracket scale option
- - - - - - elimination 70%-bracket

Figure 3. Net income at present and proposed rate



– – – Income subject to levy ——— Income subject to levy minus levy ——— Taxable income minus tax (rate 1985)

Contribution part of rate remains identifiable

The contribution part remains identifiable by the individual taxpayer, and the revenue is paid to the social security funds by the tax administration. The contributions can be individually adjusted if necessary, which is then translated into a rise or fall in the overall levy percentage.

Over 85% in the first bracket

The rate scale has an extended first bracket of Dfl. 45,000, so that, together with the standard deduction, the same percentage is levied on income up to Dfl. 49,250. On the basis of the figures for 1985, 88% of all levy payers have incomes within the first bracket. This is not clearly visible from fig. 2. This is why fig. 4 shows how many levy payers fall in each bracket. Fig. 4 clearly shows that the majority of the people fall in the first bracket.

This fact in itself already means a great gain in simplicity and clarity. The flat rate solves many problems connected with the current progressive tax system – for example, the taxation of income from different jobs.

Special provisions must be made for *the aged* and *non-residents* as they would suffer a considerable fall in income if the full income levy were applied.

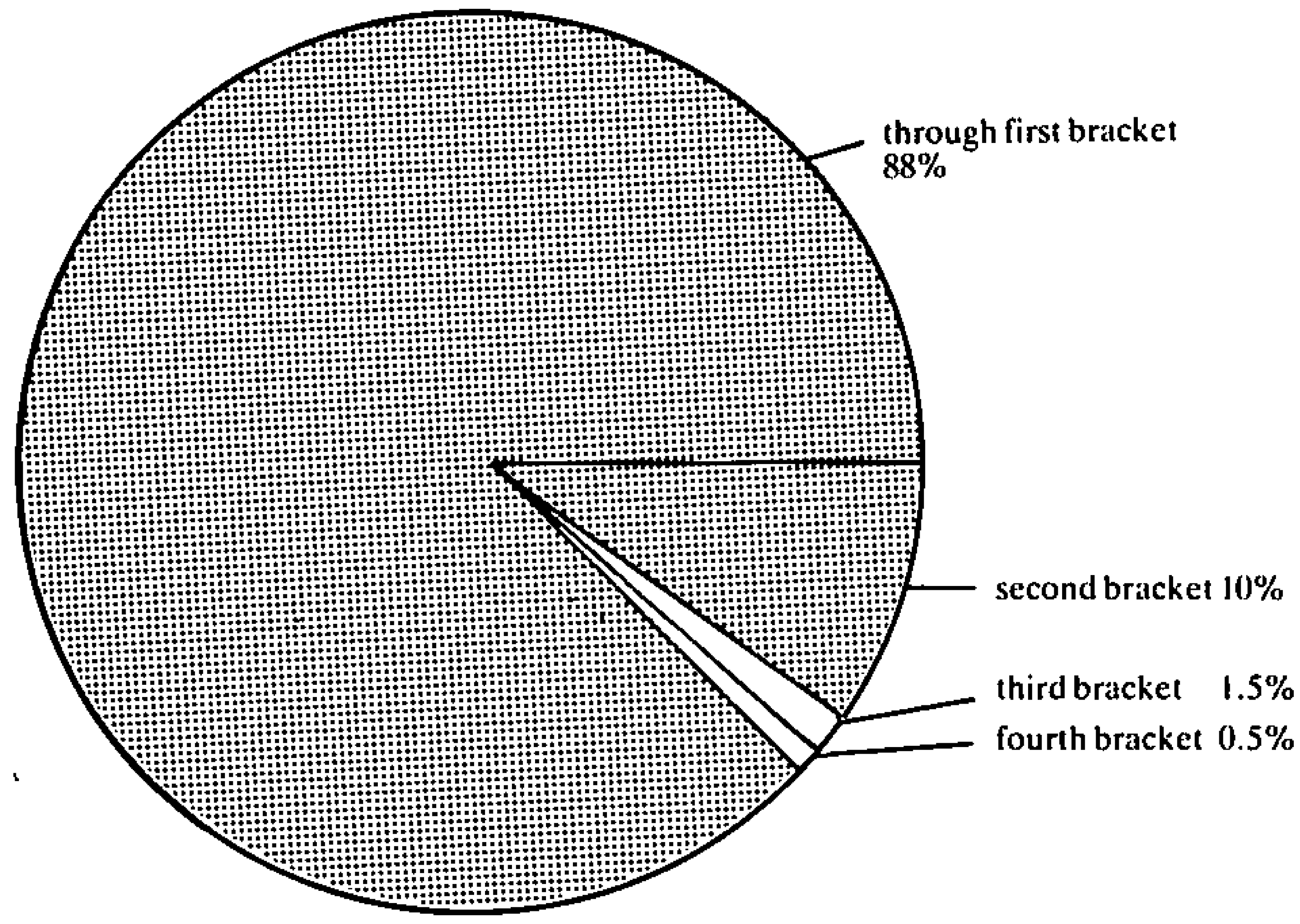
The aged

Under the present system the aged do not pay any contributions to the general social insurances. The new system provides that the pension benefits under the AOW scheme are increased (via the so-called net/net linking to the minimum wage) by the supplementary contributions. If the full 40% rate were then applied to the aged, they would also be paying AOW and AWW contributions for which they would not be receiving compensation. Consequently the Commission proposes a rate of 23.6% for the first bracket consisting of 10% tax and 13.6% contributions for the AWBZ, AKW and AAW. This lower first bracket rate for the aged produces few complications as far as the implementation is concerned, as this group is so clearly identifiable.

Non-residents

Non-residents require special treatment, insofar as they are subject to Dutch taxes and/or contributions. Since the tax and contribution components remain individually identifiable in the income levy, there are no particular problems in applying a partial levy in the first scale bracket.

Figure 4. Persons subject to income levy classified according to highest applicable rate scale



4. THE STANDARD DEDUCTION

Present exemptions complicated

There is hardly any other part of our tax legislation which is subject to so much criticism as the exemption regulations (plus extra personal allowances) developed over the past few years.

Standard deduction for everyone

The current system of standard exemptions and personal allowances is exceptionally complicated and incomprehensible. Therefore, the Commission felt it necessary to propose a fairly drastic solution in this area. This means there is to be the same standard deduction of Dfl. 4,250 for everyone. All personal allowances are abolished.

Transfer of standard deduction possible to limited extent

There is only one exception to the standard deduction: the possibility of transferring this deduction between married persons or unmarried persons who are living together. This possibility is, however, limited in various respects. Partial transfer or transfer in the course of a calendar year is not permitted. A transfer is possible only if the income of one of the two partners is less than Dfl. 4,250. This last requirement limits the transfer to cases in which the standard deduction would otherwise be lost. Transfer between unmarried partners is possible only if they are both 18 or older and have been registered at the same address with the local Registrar's Office for at least one year without there being any question of clearly separate living units. In all cases, application for the transfer must be made to the local tax inspector before the beginning of the calendar year.

Compensation for too sharp a fall in income

The abolition of all allowances is a drastic measure which simplifies matters a great deal, but which also has substantial effects on income in some cases. For most of those cases the Commission indicates how compensation can be made for these effects through specific measures. The microeconomic simulations carried out show that the effects on income in these cases actually remain within the set limits as a consequence of the proposed accompanying measures.

Single people, limited fall in income

Single people constitute a category which should be discussed separately. The abolition of the presently existing single person's allowance means a fall in income – albeit a limited one – for this group. The Commission regards this as the price which has to be paid for the major practical advantages of a system with a standard deduction which is the same for everyone. Unless we are prepared to pay this price, re-introduction of a single person's allowance in one form or another is unavoidable. The Commission has not, however, been able to find a solution which would not seriously harm the simplification, would not interfere with privacy and would not complicate implementation.

One-parent families

The abolition of currently existing allowances for single parents who are raising children under the age of 12 would produce such a drop in income that the Commission felt it had to sacrifice some simplicity. These parents are entitled to a special deduction of Dfl. 3,200. If the parent works away from the home, an additional deduction is granted at 6% of net earnings, with a maximum deduction of Dfl. 4,200.

5. SIMPLIFICATION ASPECTS OF THE INCOME LEVY

Summary of rate proposals

The above can be summarized briefly as follows. Everyone has a standard deduction of Dfl. 4,250, which he or she can transfer in certain circumstances to a partner, who would then have a deduction of Dfl. 8,500. Salaries and benefits are grossed up with the supplementary contributions, and all income – including that of the self-employed – is subject to the same income levy. The only exception is for the aged, who have their own rate for the first bracket. The income levy is 40% for the first large bracket of Dfl. 45,000. The subsequent brackets have rates of 55 and 65%, with an extra top rate of 70% in one of the two rate options presented.

Simplifications achieved

The proposed system results in a substantial simplification not only for taxpayers, but also for employers and the tax authorities. This is explained in detail in the Report. In this summary only a few items can be indicated.

One assessment, one wage levy

Most people currently receive an annual income tax assessment and a contribution assessment. Instead of two notices of assessment, the individual in the simplified system would receive only one income levy assessment. Currently, there are deductions at source from wages, pension and social security benefits for income tax and AOW and AWW contributions, while the employer and/or the benefit-paying agency pays the remaining supplementary contributions. In the simplified approach, only one withholding is made, the *wage levy*, and the supplementary contributions are absorbed in the wage levy.

Fewer brackets

The scale structure with a maximum of four brackets is much simpler than the current one. Moreover, the vast majority of people (88%) fall in the first bracket. There is one standard deduction which is the same for everyone, and which can only be granted through one employer or benefit-paying institution.

One withholding percentage

The employer only needs to withhold according to the 40% rate, since everyone who falls in a higher bracket receives an assessment in any case. Any shortfall in the wage levy is assessed separately. This achieves a considerable simplification. Because of the large first bracket, the wage levy can be the final levy for many people. In other words, no tax return need be filed and no assessment need be imposed. Taxpayers and employers will know exactly where they stand: the wage levy is 40 cents of every guilder earned above the standard deduction. Since the correct percentage is withheld at source, people with two jobs or the aged with AOW pension benefits and a (small) private pension no longer receive an assessment as long as they remain within the first bracket. Their employer, the pension fund or the benefit-paying agency, will always deduct a 40% wage levy.

Withholding tax tables unnecessary

In fact all present tables for withholding the wage tax may be discarded: the yellow, white, green, pink and orange tables. There remains only one withholding percentage of 40%, with the exception for the aged, whose withholding rate would be 23.6%. As employers in general do not employ the aged and AOW pension benefits go only to the aged, this exception does not constitute a complication. The small group of non-residents, for whom the rate may apply only partially, hardly constitutes a complicating factor either.

6. DEDUCTIONS AND OTHER ELEMENTS OF THE LEVY BASE

Deductions increase complexity ...

The current wage and income tax system has a large number of deductions of a widely differing nature, significance, and background. Most of them are derived from the ability-to-pay principle (for example, medical expense deductions); others permit a tax deferral (for example, deduction for pension contributions); and still others can be regarded as an instrument of Government policy (for example, the WIR investment premium). It is primarily this jungle of deductions which makes our tax system so complicated and incomprehensible. Consequently, the Commission had to examine carefully each deduction for possible simplification.

List of abbreviations

AAW	Disability Insurance
AOW	Old Age Pension
AKW	Child Allowances
AWBZ	Special Medical Benefits
AWW	Widow and Orphan Pension
BTW	Value Added Tax
WIR	Investment Account

... and lead to higher rates

There are, however, other – at least as important – aspects which have been considered. Deductions reduce the revenue from taxation. It has already often been argued that, if there were to be abolition or drastic reduction of deductions, income tax rates could be lowered considerably. This is in itself desirable, but it also forms the condition for the simplification itself as a less detailed tax legislation is more readily acceptable at low rather than at high rates. It is tempting to try to break out of this vicious circle through a drastic restriction of deductions.

Drastic restriction of deductions ...

In an appendix to the Report, the Commission shows what a drastic reduction of deductions would produce. With the abolition of every deduction that could reasonably be abolished without arriving at an absurd situation, a reduction of rates in the order of 2 to 3 points in each bracket is possible.

... seems socially unfeasible

The feasibility of this exercise must not be rated too highly. Most – and certainly the most important – deductions are so strongly held to be socially justifiable or are so directly connected with earning personal income that abolition or any substantial reduction would have no chance of political or social acceptance. In some cases (for example, the deduction of interest not connected to a source of income) abolition would lead to such complications that a recommendation of this type is certainly outside the scope of a simplification commission.

Greatest deduction has, however, been dropped ...

What remains is a series of simplifications of deductions and some other regulations which as a whole do not bring in much revenue (Dfl. 1,500 million or 0.7 point of each bracket). The abolition of the largest deduction, i.e. for the contributions, is not included in this figure as it is already absorbed into the basic rate of the income levy. Through the proposed simplifications, a streamlining of the system is achieved which in itself fulfils the assignment. There is little point in this summary to mention the whole series of proposals for simplification of deductions. Some are briefly discussed below. The reader is referred to the Report for more details.

... and other proposals result in streamlining

The Commission thinks that the extraordinary expenses allowance can be simplified on a number of points: dispensing with the multiplication factors in the medical expense scheme, a simpler scheme for special dietary expenses, excluding contributions for medical expense insurance, and a reduction and simplification of the present threshold. A simplification of the travel expense deduction is possible by excluding the standardized deduction for the shortest distance.

Other proposals do not relate to deductions, but do lead to simplification and in most cases to a higher revenue. The Commission recommends, inter alia, valuing holiday vouchers in the same way as other wages. Other proposed simplifications concern the abolition of the so-called income averaging regulation and the replacement of the complicated special income tax rate by a simpler method of calculation.

Special rate relief for the self-employed

Self-employed people with a taxable income up to approximately Dfl. 22,000 can currently avail themselves of the special provisions reducing their liability for contributions. In view of the low standard deduction, the Commission sees great problems in simply abolishing this regulation. It therefore proposes a provision to prevent this group with very low incomes (largely below the minimum wage) from suffering a setback.

Simplification for taxpayer, employer, and tax administration

Simplification of deductions and of other elements in the levy base benefits various parties: the taxpayer, who is no longer forced to keep detailed accounts in order to substantiate the use of a deduction in his return, and who may not need to file a return because the wage levy will more often be the final levy; the employer, who must process fewer wage levy forms; and the tax administration, which no longer needs to check the abolished deductions and is relieved of the complications of other regulations.

Certain income shifts unavoidable

Here again, the fact is that simplification is not possible if nobody is to be adversely affected in his or her income. Streamlining of deductions and other provisions undoubtedly results in certain income shifts. The shifts are, however, limited. For detailed calculations on the basis of microeconomic simulations for different social groups, the reader is again referred to the Report.

Table 2. Percentage changes in net disposable income of employees in the market sector

Current gross wage	Current taxable income	Income subject to proposed income levy	Scale group I[a]	II[b]	III[c]	IV[d]
20,000	16,650	21,890	–2.5	–6.3	1.2	.0
25,000	20,840	27,400	–1.3	–6.2	–0.1	–1.2
25,641[e]	21,320	28,020	–1.2	–6.0	–0.3	–1.3
30,000	24,360	32,030	–0.3	–4.9	–0.8	–1.2
35,000	27,860	36,630	1.5	–3.7	–0.2	–0.5
40,000[f]	31.360	41.230	3.0	–1.9	0.4	0.6
45,000	34,730	45,660	4.2	–0.3	1.7	1.9
50,000	38,040	50,010	4.8	0.6	2.6	3.0
60,000	44,650	58,710	4.3	–0.5	2.2	2.1
70,000	51,270	67,400	4.1	–0.2	2.0	2.1
80,000	60,080	77,360	4.3	–0.4	0.7	1.1
90,000	69,570	86,850	2.6	–1.5	0.1	0.4
100,000	79,060	96,340	1.4	–3.1	–1.8	–1.5
125,000	102,780	120,070	0.1	–3.9	–3.1	–2.8
150,000	126,510	143,790	–0.6	–4.2	–3.2	–3.0

a) Double income families and single persons under 27 years.
b) Single persons 27 and older.
c) Single income families.
d) One parent families.
e) Gross minimum wage.
f) Gross modal wage.

Table 3. Percentage changes in net disposable (family) income for the aged[a]

Current gross income	Current taxable income	Income subject to proposed income levy	Married	Single
13,873[b]	13,473	15,670		–0.4
15,000	14,600	16,800		–1.0
20,000	19,600	21,800		–3.0
·20,038[c]	24,638	26,835	–0.4	
25,000	24,600	26,800	–2.0	–2.2
30,000	29,600	31,800	–2.1	–0.9
35,000	34,600	36,800	–1.3	0.8
40,000	39,600	41,800	0.2	2.2
45,000	44,600	46,800	1.4	4.3
50,000	49,600	51,800	2.9	4.1
60,000	59,600	61,800	5.6	1.8
70,000	69,600	71,800	4.2	0.9
80,000	79,600	81,800	3.3	1.3
90,000	89,600	91,800	4.0	0.8
100,000	99,600	101,800	3.6	0.1
125,000	124,600	126,800	3.3	0.6
150,000	149,600	151,800	3.2	0.4
200,000	199,600	201,800	2.6	0.4

a) For married persons; the taxable income for single persons is Dfl. 200 higher than that for married persons with the same gross income.
b) AOW for single persons.
c) AOW for married persons.

7. INCOME CONSEQUENCES

Social minimum practically unchanged

It will be clear that the proposals developed by the Commission do have consequences for the *income position* of almost everyone. Simplification inevitably means less precision. The Commission took as its basis the distribution of net income existing in 1985 and does not give an opinion on the acceptability or fairness of that distribution. Its intention was to leave undisturbed the income distribution existing in 1985.

Vast majority increase or decrease no more than a few hundred guilders

People with an income in the region of the social minimum should not be affected by the rate operation. The disposable income of others should not, in principle, increase or decrease by more than 5%. These boundaries are practically never breached. The vast majority of people experience an increase or decrease of no more than a few hundred guilders a year.

Table 2 shows the income change percentages for various income groups as a result of the rate operation in the rate option with four brackets. The table relates to employees; for the self-employed the situation is not very different. Table 3 gives the income change percentages for the aged. It can be deduced from both tables that the criteria have been met almost in all cases. Here it should be mentioned that the combination of the standard deduction and the rate is deliberately chosen to achieve this result. The level of the standard deduction was specifically chosen to prevent a fall in income for the lower incomes, with the largest possible first bracket. This means that the rate for the first bracket cannot be too low, otherwise revenue neutrality is threatened and the positive shift in income at the end of the first bracket becomes too great.

Simplification takes a certain toll

It is not practical to give surveys such as those tables 2 and 3 in which all

Members of the Commission:

Chairman: C.J. Oort; **Members:** H.P.A.M. van Arendonk, P. den Boer, Prof. H.J. Hofstra, C.A. de Kam, H. Mobach, W.F.C. Stevens, N. Vogelaar, H. Burger (member and secretary), H. Baron van Lawick (deputy member and secretary), A.B.W.M. Hartman (assistant secretary), E.B. Jaspers (assistant secretary), H. Mooij (assistant secretary).

proposals of the Commission are reflected. For information on this, refer to the Report. It can be seen from the tables in the Report that a limited group of taxpayers (less than 5%) lose somewhat more than 5% in purchasing power. It seems the inevitable price to pay for simplification of the taxation system. One cannot have simplification without paying a certain price. It is tempting to make exceptions for all kinds of "affected" groups. This temptation must be resisted. Otherwise, the potential gain from simplification risks being drained away by renewed complexity.

The problems experienced by "small" double wage earners disappear as a result of the proposed rate structure. Presently the husband must often pay more tax at a higher rate when the *wife* works outside the home. As long as the partners each earn less than Dfl. 50,000 per annum, they will each pay 40% under the new rate structure. From the calculations of the Commission it appears that the relative position of the single wage earner, in comparison to double wage earners, is not negatively affected until their income approaches Dfl. 70,000.

8. CONCLUDING REMARKS

Proposals: feasible and socially acceptable ...

The Commission is convinced that its proposals contain a sensible, feasible and socially realistic package of simplification measures. The proposals contain measures which bring about a considerable reduction of the current administrative workload for all concerned – for individuals in the first place, but also for those who have to withhold the tax, and for the tax administration.

... and produce actual simplification

The combining of tax and contributions, the fixed rate of the combined levy over a large bracket – by means of which many of the problems related to the progressive rate system would be solved automatically for a large number of people – and the simple standard deduction for everyone can be described as an important simplification which will be experienced as such by many people.

The various proposals permit personnel savings of 1,400 to 1,700 working years for the tax administration (4 to 5% of total manpower). If other savings at the tax administration are taken into account, there is a total potential savings of Dfl. 85 to 110 million a year.

Rate reduction impossible due to revenue neutrality requirement

A genuine reduction in rates was not possible, given the revenue neutrality requirement. There is a wide-spread illusion that simplification could lead to a drastic reduction in rates. Oversimplified calculations, based on proposed measures which are too drastic to be socially acceptable, have fed this illusion. It should again be emphasized that in an economy in which about two thirds of the national income flows through the public sector, taxes and contributions will never be as low as is considered possible in some other countries.

Of course, the Commission could have presented further-reaching proposals in this respect, for example by proposing a shift from wage and income tax to VAT (in which case each additional point on the standard and reduced VAT rates permits a reduction of almost one point in all income levy rates). The Commission did not consider this a part of its assignment. Such a shift can, however, be added to our proposals very easily. The lower the rates, the more possible and acceptable further simplification becomes.

That is no excuse for delay

Plans for the more distant future have deliberately not been produced in order to avoid diverting attention from the difficult short-term problems. There is a great danger that the initial steps which are not simple might otherwise be deferred, and possibly discarded with the excuse that it is necessary first to make a further analysis of an even better future policy.

That would be a recipe for failure. The Commission is convinced that what it is proposing is feasible in the short term, produces a considerable improvement, and by no means stands in the way of – on the contrary, constitutes the necessary first series of steps for – a further simplification which may prove possible in the more distant future.

Now let the Government and the Parliament put their back into it and bring about what is currently within reach.

Conference Diary

JUNE 1986

Hartford Institute on Insurance Taxation: Third Annual international conference on insurance taxation. London (United Kingdom), 29 June-2 July (English).

JULY 1986

European Study Conferences Limited: Tax and benefit planning for personal pensions. London (United Kingdom), 1 July (English).

European Study Conferences Limited: Stamp and capital duties 1986. London (United Kingdom), 1 July (English).

IFA Singapore Branch: Lesser known aspects of tax treaties. Singapore, 31 July (English).

SEPTEMBER 1986

40th Annual Congress of IFA: 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).

Management Centre Europe: Leasing (Training programme). Brussels (Belgium), 23-26 September (English).

IFA Singapore Branch: Congress paper review – tax residence/liquidations. Singapore, 25 September (English).

International Tax Planning Association: The protection and collection of information; Monte Carlo Workshop. Monte Carlo, Monaco, 25-26 September (English).

Bureau of European Taxation and Trade: The taxation of overseas partnerships in Europe (Symposium). London (U.K.), 29 September (English).

OCTOBER 1986

IFA Singapore Branch: Dividend payments – Singapore and Malaysia. Singapore, 30 October (English).

NOVEMBER 1986

IFA Singapore Branch: Annual General Meeting. Singapore, 27 November (English).

FOR FURTHER INFORMATION PLEASE WRITE TO:

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Hartford Institute on Insurance Taxation, Professor Bernard B. Goodman, Avon Commons, 49 West Main Street, Avon, Connecticut 06001, U.S.A.

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

International Fiscal Association (I.F.A.), Singapore Branch, Paul Ellard, 9 Penang Road, 12 Floor Supreme House, Singapore 0923.

International Tax Planning Association, 33a Warwick Square, London SW 1V 2AD, United Kingdom.

Legal Studies & Services Ltd., IBC House, Canada Road, Byfleet, Weybridge, Surrey KT 14 7JL. United Kingdom.

Management Centre Europe. The Registrar, rue Caroly 15, B-1040 Brussels, Belgium.

INTERNATIONAL FISCAL ASSOCIATION NEWS

ANNUAL MEETING U.S.A. BRANCH:

The Proposed Branch Level Tax in the U.S.A.

By John A. Corry and Robert K. Decelles

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I. CURRENT LAW

The manner in which foreign controlled U.S. business activities are subjected to U.S. taxation depends upon whether such activities are carried out in U.S. subsidiary or branch form.

A. Subsidiary form

1. Where a U.S. subsidiary (controlled by foreign shareholders) is used to conduct U.S. business activities the following taxation scheme is applicable.

(a) The taxable profits of the U.S. subsidiary (determined in the same manner as any other U.S. corporation) are subject to normal corporate tax.
(b) Distributions of after-tax profits to foreign shareholders are subject to a gross 30% (or lower tax treaty rate) withholding tax at source. Many U.S. tax treaties reduce the withholding tax rate to an amount ranging from 5%-15%.
(c) Interest paid with respect to foreign debt is generally tax deductible and is subject to a gross 30% (or lower tax treaty rate) withholding tax at source. Many U.S. tax treaties substantially reduce or completely eliminate this tax on interest payments.

B. Branch form

1. Where a foreign corporation conducts business activities in the U.S. through a branch, the following taxation scheme is applicable.

(a) The taxable profits of the branch are determined using the complicated "effectively connected" concepts of Sec. 864/882 and are subjected to normal corporate tax.
(b) Distributions of after-tax profits of the U.S. branch to its head office are free of U.S. taxation. Dividend distributions by the foreign corporation to its shareholders would only be subject to a 30% (or lower U.S. tax treaty rate) withholding tax (so-called second dividend tax) if more than 50% of its gross income (over a 3-year period) was derived from its U.S. trade or business. Many U.S. income tax treaties eliminate this second-level dividend tax.
(c) Interest paid with respect to foreign debt by the foreign corporation would be tax deductible in the U.S. under the formula approach of Reg. Sec. 1.882-5 and would only be subject to a 30% (or lower tax treaty rate) U.S. withholding tax if more than 50% of its gross income (over a 3-year period) was derived from its U.S. trade or business. Again, many U.S. income tax treaties eliminate this second-level interest tax.

Thus, under present law, the Ways and Means Committee concluded that there was an undesirable incentive for foreign corporations to operate in the U.S. in branch form and thereby gain competitive advantages (because of a less burdensome taxation scheme) over U.S. corporate competitors.

II. WAYS AND MEANS PROPOSALS

A. Repeal of second-level tax

1. The second-level dividend and interest tax would be repealed effective for taxable years beginning after 31 December 1985.

(a) Where such repeal is inconsistent with existing U.S. tax treaty obligations, and such treaty allows a second-level withholding tax, the existing second-level taxes will continue to apply.
   - However, such existing treaties will not be available for use on a "treaty shopping" basis by non-residents (i.e. corporations that are not controlled by individual residents of the treaty country) of the treaty country.
(b) Where such repeal is inconsistent with existing U.S. tax treaty obligations, and such treaties do not allow for a second-level withholding tax, the treaty will take precedence over the branch level tax.
   - Again, in treaty shopping situations this benefit will not be available (see Section III below).

B. Branch level tax

1. In place of the second-level dividend and interest tax, new Code Section 883 would impose an additional 30% tax on the after-tax profits of U.S. branches (div-

idend equivalent amount) and on certain interest payments by the foreign corporation (allocable interest amount).

(a) The "dividend equivalent amount" is defined as the foreign corporation's taxable income effectively connected with the conduct of a U.S. trade or business with the following adjustments:
   (i) reduced by the U.S. corporate income tax after any tax credits;
   (ii) reduced by any increase in "U.S. net equity"; and
   (iii) increased by any decrease in "U.S. net equity".

   The increase or decrease in U.S. net equity is determined by comparing the adjusted basis of the branch's assets less liabilities at the beginning of the tax year and at the end of the tax year. The Committee Report indicates that Treasury Department Regulations are intended to address the potential abuse that may arise in the event a branch temporarily increases its assets at the end of its taxable year merely to reduce the branch level tax base. Likewise, such regulations are also intended to address the extent to which a decrease in assets may not indicate that the branch has remitted profits during the year.

(b) The allocable interest amount is defined as the amount of interest paid or accrued by the foreign corporation during the taxable year to the extent that it is:
   (i) allowed as a deduction in arriving at U.S. effectively connected taxable income; and
   (ii) would be subject to U.S. withholding under Sections 1441 or 1442 if the foreign corporation was a U.S. corporation.
   (a) This second requirement eliminates a number of items from inclusion including:
   (1) original issue discount on short-term obligations;
   (2) interest that is effectively connected to the recipients' U.S. business;
   (3) portfolio interest; and
   (4) bank deposit interest.

(c) The Committee Report indicates that if the foreign company is a resident of a country that has an income tax treaty with the U.S.A. and such treaty reduces U.S. tax on dividends, then such reduced rate is to be applied (in lieu of 30%) to *both* the dividend equivalent amount and the allocable interest amount. This provision will not be applicable in "treaty shopping" situations.

   Example: West German corporation X operates a branch in the U.S. The dividend equivalent amount of such branch is $100 and the allocable interest amount of $50. Article VI of the U.S.–German Income Tax Treaty reduces U.S. withholding on dividends received by a German company from a U.S. corporation to 15%. Article VII of the treaty eliminates U.S. withholding tax on U.S. source interest received by a German resident. The entire $150 ($100 dividend and $50 interest) would be subject to a 15% branch level tax, notwithstanding the treaty exemption for interest payments.

C. Tax credit

1. If the branch level tax applies to the dividend equivalent amount, 10% or greater U.S. corporate shareholders (of the foreign corporation with a U.S. branch) will be entitled to a tax credit equal to such branch tax.

Example: A U.S.-controlled foreign corporation earns $100 of income through a U.S. branch. It does not retain after-tax income in such branch but distributes such amount to its sole U.S. corporate shareholder. Such shareholder would be entitled to a tax credit of $19 ($100 less normal U.S. tax 36 x 30%).

This rule would seem to create another difference between the U.S. tax treatment of a subsidiary and branch (this difference favoring a branch) which seems to be contrary to the stated intention of the legislation.

III. EFFECT OF U.S. INCOME TAX TREATIES

A. The Bill and Committee Report

1. Most U.S. income tax treaties contain "non-discrimination" clauses that are intended to prevent the United States under the circumstances set forth therein from taxing a foreign treaty country resident more heavily than a United States person that is similarly situated. From the text of proposed Section 883, it is not entirely clear how the branch tax would be affected by these non-discrimination provisions.

(a) Section 883(d)(2)(A) provides that if a treaty that can be invoked by a foreign taxpayer "does not permit a branch tax on allocable interest", but does permit a withholding tax on interest described in Code Section 861(a)(1)(C), Section 861(a)(1)(C) will still apply to such amounts "paid to such taxpayer". A "similar rule" would apply to dividends described in Section 861(a)(2)(B).

(b) Under Section 883(c)(2)(B), if a treaty prohibits both a branch tax and a Section 861(a)(1)(C) tax and more than 50% of the stock of the foreign corporation is beneficially owned (or deemed owned under the Section 958(b) attribution rules) by non-residents of the foreign country treaty party, "the amendments made by this Section shall apply to allocable interest notwithstanding such treaty obligation to the contrary" and a "similar rule shall apply in the case of amounts described in Section 861(a)(2)(B). . ." This treaty shopping rule will not apply to a foreign corporation which is primarily and regularly traded on an established securities market in the country of which it is a resident.

2. This language is unclear and confusing. The Committee Report is considerably more helpful.

(a) The Committee Report states that "in general" the branch level tax is not to apply where it would be "inconsistent with an existing U.S. income tax treaty obligation". After suggesting that a branch tax "does not unfairly discriminate against foreign corporations because it treats foreign corporations and their shareholders together no worse than U.S. corporations and their shareholders", it states that where third country investors are not using a treaty to avoid the branch tax, "the Committee is willing to allow the provisions of a treaty that prohibit imposition of a branch tax to take precedence over the tax, even though as later enacted legislation the tax would normally override the treaty."

(b) If a treaty does not allow the branch tax but does allow the existing second level tax on either interest or dividends, the second level tax is still to apply.

(c) In treaty shopping situations, the branch level tax will apply notwithstanding a treaty prohibition.

3. The Administration's branch tax proposals would also permit existing treaties to override the legislation, but would instruct the Treasury Department to seek to amend those treaties that prevent the imposition of such taxes.

B. Analysis of tax treaty provisions

1. The Committee Report does not indicate what types of treaty provisions are "inconsistent" with a branch tax. Thus, an analysis of the treaties themselves is required. There are generally three categories into which treaties may be classified in this respect:

(a) those that permit such a tax specifically or by omission of a prohibition;
(b) those that rather clearly prohibit the tax; and
(c) those that arguably prevent the tax.

2. Treaties that permit the tax:

(a) The treaties with Australia (Art. 10(6)), Barbados (Art. 24.2), Canada (Art. X(6), France (Arts. 13(2)(a) and 24(2)), New Zealand (Art. 23.2(b)), and Trinidad and Tobago (Arts. 6(2) and 12(5)) specifically permit the imposition of special branch profits taxes.
Several of these treaties limit the rate of tax; Australia (15% of the taxpayer's taxable income reduced by its regular income tax); Canada (10% of earnings not previously subjected to such tax), France (15% of 2/3 of the French tax base; a U.S. tax may be "comparable"), New Zealand (5%) and Trinidad and Tobago (10%).

(b) In the Polish (Art. 23(2)), Romanian (Art. 22(2)) and Russian (Art. X(2) treaties, the non-discrimination clauses compare the tax imposed on a treaty country taxpayer with that imposed on a taxpayer of a "third country". Since each of these countries and the United States is not barred by imposing a branch level tax on a resident of a non-treaty country, these treaties do not forbid the imposition of a branch tax.

(c) The non-discrimination provision in the treaty with South Africa (Art. III(2)) applies only to South African citizens residing in the United States.

3. A substantial number of treaties appear to prevent imposition of the tax. They contain provisions similar to Art. 24(3) of the Treasury's Proposed Model Income Tax Treaty, which reads as follows:

> The taxation of a permanent establishment which an enterprise of a Contracting State has in the other Contracting State shall not be less favorably levied in that other State than the taxation levied on enterprises of that other State carrying on the same activities.

(a) Treaties that contain such provisions are those with Belgium (Art. 24(2)), Cyprus (Art. 7(2)), Denmark (Art. 24(3)), Egypt (Art. 26(2)), Finland (Art. 7(2)), Hungary (Art. 21(2)), Iceland (Art. 7(2)), Italy (Art. 24(2)), Jamaica (Art. 25(2)), Japan (Art. 7(2)), Korea (Art. 7(2)), Malta (Art. 25(2)), Morocco (Art. 22(2)), Netherlands (Art. XXV(3)), Norway (Art. 25(2)), the Philippines (Art. 24(2)), and the United Kingdom (Art. 24(2)).

(b) The treaties with the following countries either permit or do not prevent the imposition of a second level tax and therefore, with respect to corporations that are residents of those countries, second level dividend and interest taxes would continue to apply: Denmark (Art. 10(6) (dividends in certain treaty shopping cases) and Art. 11(1) (interest paid to non-residents of Denmark)), Egypt (Arts. 11(1), 12(1) and (4)), Finland (Art. 12(2) (dividends) and Art. 12(1) (interest paid to non-residents of Finland)), Hungary (Art. 10(1) (interest paid to non-residents of Hungary)), Italy (Art. 11(1) (interest)), Jamaica (Art. 11(1) (interest)), Japan (Arts. 12(1) and 13(1)), Korea (Arts. 12(1) and 13(1)), Malta (Art. 11(1) (interest)), Morocco (Art. 11 (interest)), Norway (Arts. 8(4) and 9(7)) and the Philippines (Arts. 11(3) and 12(1)).

4. The remaining treaties contain provisions that arguably prevent imposition of the branch tax. An example of such language is Article XVIII(3) of the Austrian treaty, which reads:

> The citizens of one of the Contracting States shall not, while resident in the other Contracting State, be subjected therein to other or more burdensome taxes than are the citizens of such other Contracting State residing in its territory.

(a) Except for the Irish treaty with respect to Irish nationals (Art. XXI), all those treaties provide that "citizens" include "all legal persons, partnerships and associations".[1] These treaties are with Austria (Art. XVIII(3)), Germany (Art. XVIII(3)), Greece (Art. XVI(3)), Luxembourg (Art. XX(3)), Netherlands Antilles (Art. XXV(3) of previous Netherlands treaty)), Pakistan (Art. XVII), Sweden (Protocol Para. 7) and Switzerland (Art. XVIII(3)).

(b) It would appear, for the purpose of these provisions, that to the extent that it has a U.S. permanent establishment or otherwise carries on a U.S. trade or business, a foreign corporation is "resident" in the United States.

1. In a few of these treaties, "juridical persons" is substituted for "legal persons".

(i) Treas. Reg. 301.7701-5 provides that a foreign corporation that is engaged in a U.S. trade or business is a "resident foreign corporation".

(ii) In Ltr. Ruling 7846060, the Service held that a "foreign corporation having income that is effectively connected with the conduct of a trade or business in the United States is considered a resident of the United States to the extent of such effectively connected income". On that basis, the Service determined that the non-discrimination provisions of the U.S.–German treaty prevented the imposition on a German reinsurance corporation of the excise tax imposed by Code Section 4371(3) on reinsurance contracts or treaties.

(iii) The contrary interpretation would effectively negate any significance to the inclusion of "legal persons, partnerships or associations" in the definition of "citizens" resident in the United States.

(iv) It has been suggested that the 1966 amendment to Article XXV(3) of the Netherlands treaty, which specifically makes U.S. permanent establishments of Netherlands corporations eligible for non-discrimination treatment, indicates that the contrary result should be reached under the earlier version of that provision (which still applies to the Netherlands Antilles). However, the official explanation of the change merely states that the "original paragraph (3) contained a similar but less comprehensive prohibition against discriminatory tax treatment". The explanation does not state that the prior version did not apply to a U.S. branch of a Netherlands corporation; at most, it implies that the prior version may have been ambiguous.

(v) The Senate should clarify the applicability of the branch tax to such treaty countries.

(c) The treaties with Pakistan (interest (no provision)), Sweden (dividends (Art. VII(1)) and interest paid to Swedish non-residents (Art. VIII)) and Switzerland (Art. XIV(1) (payments to Swiss non-residents)) do not prevent the imposition of second level taxes on dividends and interest. Therefore, with respect to these treaties, the second-level tax would continue to be applicable.

5. Miscellaneous points:

(a) An additional treaty restriction involves treaty country corporations that are engaged in a United States trade or business but do not have a United States permanent establishment. Most treaties provide that the "industrial or commercial profits" or "business profits" of a treaty resident may not be taxed by the other treaty party unless such person has a permanent establishment in such treaty country to which such profits are attributable. See, e.g., Canadian Treaty, Art. VII. Such treaty provisions should prevent the imposition of the branch tax in such circumstances to the same extent that they prevent the imposition of the U.S. corporate income tax. This result is apparently confirmed by proposed Section 883(a), which commences, "In addition to the tax imposed by Section 882. . ."

(b) These income tax treaty non-discrimination provisions probably had their genesis in non-discrimination provisions contained in commerce and navigation treaties between the United States and a number of foreign countries. Some of these treaties contain broad prohibitions upon the imposition of taxes (including income taxes) on corporations of either contracting party that are more burdensome than those borne by corporations engaged in business in such countries. See, e.g., Italian Treaty, Art. IX(1) and French Treaty, Art. IX(1)(c). The United States could have a commerce and navigation treaty relationship with a foreign country with which it does not have an income tax treaty, or an income tax treaty that does not contain a non-discrimination clause that clearly prohibits the operation of a branch tax. An example of the former is Art. XI(1) of the Friendship, Commerce and Navigation Treaty with Israel (with which an income tax treaty has been signed but never ratified) under which the "companies" of either country "engaged in trade or other gainful pursuant" within the other country shall not be subject to income taxes that are more burdensome than those borne by companies of the other country. It is not clear from the language of the Bill and the Committee Report whether such non-discrimination clauses are intended to override the branch tax provisions of the Bill. This is another point that the Senate should clarify.

IV. PROS AND CONS OF PROPOSAL

A. Pros

1. It provides a system of taxation that results in the U.S. tax burden imposed on a branch's profits being more comparable to the U.S. tax burden imposed upon subsidiary profits.

2. Provisions that are very difficult to administer and enforce are removed from the Code.

B. Cons

1. It introduces concepts that are extremely complex and difficult to implement.

2. It fails to achieve comparable treatment of branches and subsidiaries and in fact puts branches at a distinct disadvantage in most situations.

3. The objective of equal/comparable tax treatment for branches and subsidiaries disregards the many other tax and non-tax differences between the two forms of business operations.

On balance, the proposed tax would likely generate more tax revenue than that produced under the existing arrangement, but at the cost of substantial administrative and compliance problems.

SWISS CHAPTER OF IFA

GUIDELINES FOR A DOUBLE TAXATION POLICY IN SWITZERLAND

By Dr. H.K. Lüscher

One can note a growing trend during recent years to use double taxation treaties for purposes which lie outside their objective of avoiding double taxation. Switzerland has always endeavoured to conclude treaties, with few exceptions, which were patterned on the OECD Model Agreement of 1963/77. One example of the non-conformance with the Model Treaty is the reservation relating to the Article dealing with the exchange of information. It is the Swiss view that the double taxation treaties can only provide for the exchange of the kind of information which is necessary for the treaty's correct application and avoidance of misuse.

The non-ratification of the revised treaty with France by Swiss Parliament in 1984 has prompted the Swiss IFA Chapter to devote the meeting of its members on 7 February 1986 to the subject of Switzerland's future double taxation policy. Two introductory addresses by Notary Daniel Lüthi, Director of the Department for International Tax Law and Double Taxation at the Federal Tax Administration, Berne, and Maître Raoul Lenz, Geneva, were followed by a panel discussion. The latter primarily sought an answer to the question if Switzerland should aim at increasing the number of its double taxation treaties or not.

The discussion clearly led to the conclusion that in view of the close integration of Switzerland's business and industry in the global economy, the removal of international double taxation must remain a permanent postulate for that country. The Double Taxation Treaty policy pursued so far has by and large stood the test of time. However, the advantages and disadvantages for Switzerland must be carefully weighed in collaboration with all interested groups in politics and business life during any new treaty negotiations. The meeting reasoned that the conclusion of double taxation treaties at any cost must be rejected.

DOUBLE TAXATION CONVENTIONS

Survey of the Swiss treaty practice*

By D. Lüthi

INTRODUCTION

Switzerland tends to conclude double taxation conventions primarily for economic reasons. Such treaties are intended to facilitate Swiss investments abroad and thereby to promote economic relations.

However, double taxation conventions are not concluded at any price. Although there is no doubt that the Swiss treaty policy must offer sufficient flexibility, it must at the same time follow certain principles which may represent an obstacle to the conclusion of a convention. Since international tax law is subject to continuous changes, these principles must constantly be re-examined and if necessary adapted.

This article will summarize the most important subjects to be dealt with when concluding new conventions or when revising existing ones and the principles underlying the Swiss treaty practice in relation to these subjects. A distinction is made between industrialized countries, State trading countries and developing countries.

* Summary of a talk held at the Swiss IFA Branch meeting of 7 February 1986 in Basel. Mr. Lüthi is Vice-Director of the Swiss Federal Tax Administration.

1. Industrialized countries

With respect to industrialized countries, the Swiss treaty practice follows closely the solutions contained in the OECD Model Convention 1963/77 (OECD). The only exceptions concern profit adjustments to be made in the case of associated enterprises (Art. 9, para. 2 OECD), the withholding tax on interest (Art. 11, para. 2 OECD) and the exchange of information (Art. 26 OECD). Problems may also arise in relation to dividends, royalties and the abuse of tax conventions.

a) Profit adjustments in the case of associated enterprises

If a Contracting State makes an adjustment of the profits of an enterprise, Article 9, para. 2 OECD 1977 provides that the other Contracting State is committed to make a correlative adjustment of the profits of the affiliated enterprise if it considers that the adjustment made in the first State is justified. Switzerland has made a reservation to this provision of the OECD Model because it is not prepared to automatically grant a correlative adjustment. In addition, tax assessments entered into force can only be re-opened if particular reasons for revision laid down in the law or by court practice are given – a profit adjustment does not represent such a reason – or by way of a mutual agreement procedure within the ordinary time limits. Article 9, para. 2 OECD 1977 is therefore not inserted in Swiss double taxation conventions.

Under the mutual agreement procedure, competent authorities are not compelled to agree to a common solution. In addition, any solution must also be approved by the taxpayer involved. These difficulties could be avoided by establishing an arbitration procedure. In the European Communities, a Draft Directive on a formal arbitration procedure has been elaborated, but ratification is still pending. Furthermore, a recently initialled draft of a comprehensive convention between the Federal Republic of Germany and Sweden contains an arbitration clause. However, such an instrument may create other difficulties which, from a Swiss point of view, can be important enough to reject the idea of arbitration in the framework of double taxation conventions.

b) Dividends

Generally, it is not difficult to fix the withholding tax rates in accordance with the recommendations of the OECD. However, negotiators may be confronted with another problem. A number of countries have taken measures in order to eliminate or alleviate economic double taxation of the profits of a company and the distributed dividends by granting the domestic shareholders a tax credit for the tax paid by the company. Switzerland takes the view that such a tax credit should also be granted to Swiss shareholders, as is the case under the Swiss tax conventions with France, the United Kingdom and Ireland. The Federal Republic of Germany, having introduced the tax credit for shareholders resident in Germany in 1977, has up to now refused to grant the full credit or part of it to foreign shareholders.

c) Interest

Article 10 OECD provides for a tax at source of 10%. Switzerland, on the contrary, aims at an exclusive taxing right of the residence country of the recipient. However, a majority of industrialized countries are in favour of a tax at source, whereby some countries are prepared to reduce the withholding rate on given categories of interest or to exempt them from withholding. Amongst the 13 Swiss conventions concluded since 1970 only 3 provide for the exclusive residence principle. Therefore, it is unlikely that Switzerland will be in a position to carry through its policy in this field in the near future.

d) Royalties

According to the recommendations of the OECD Model, the Swiss policy favours an exclusive taxation of royalties in the residence country of the recipient. But numerous are the countries which ask for a limited tax at source. This situation had the result that amongst the 10 most recent Swiss tax conventions only 3 provide for the residence principle. In case it is not possible to eliminate a tax at source, the attempt is made to restrict the definition of the term "royalties" and to treat leasing payments and fees for technical services as ordinary business profits.

e) Treaty abuse

By enacting the Decree of 14 December 1962, Switzerland was the first country to take measures to combat the use of Swiss tax conventions by non-entitled persons. The provisions of the Decree and of the connected Circular Letter apply in all cases in which residents of Switzerland are taking advantage of treaty relief. Due to these measures, there is no reason to restrict the personal scope of a Swiss tax convention in order to exclude given categories of taxpayers from treaty benefits. On the other hand, the insertion of parts of the Abuse Decree in tax conventions may have undesirable effects where the domestic law of a treaty partner also provides for specific anti-abuse measures. In addition, the insertion may be refused in view of the incapacity of the treaty partner to apply the provisions of the Decree equally on his side.

f) Administrative assistance

The Swiss practice already allows an exchange of information for the correct application of a convention and for the prevention of treaty abuse on the bases of the relief procedure in respect of withholding taxes as well as in the course of a mutual agreement procedure. Therefore, Switzerland has made a reservation to Article 26 OECD (exchange of information) which also provides for administrative assistance for implementing domestic law. However, Switzerland is prepared to negotiate an exchange of information clause in respect of information necessary for the correct application of a convention.

2. State trading countries

The need to protect Swiss taxpayers from the effects of double taxation extends to State trading countries. The differences in the economic systems and the partial lack of reciprocity in relation to allowed business activities require specific solutions which may deviate from the Swiss practice vis-à-vis western industrialized countries. In order to avoid unilateral tax concessions, it may be necessary to restrict the scope of a convention to taxation rules which cover transactions allowed in both countries. In any case, provisions on the taxation of business profits, royalties and earned income must be inserted.

3. Developing countries

In general, the Swiss treaty practice follows closely the solutions of the OECD Model. But Switzerland is prepared to deviate from the Model in certain respects and to grant developing countries special concessions. These concessions are limited and can in no way result in shifting the primary taxing right to the country of source. The main problem areas concern the taxation of business profits as well as source taxation of dividends, interest and royalties. In addition, exchange of information is regularly an issue for discussion.

a) Taxation of business profits

In relation to the permanent establishment criteria, Switzerland is prepared to determine that a building site or installation project constitutes a permanent establishment if it lasts more than six months; a dependent agent maintaining a stock of goods from which he habitually fills orders or makes deliveries may also constitute a permanent establishment. On the other hand, the extension of the permanent establishment criteria to the furnishing of services through employees during a given period is, from a Swiss point of view, problematic. The imposition of a limited withholding tax on remuneration paid for the furnishing of services is unsatisfactory, but it may be conceded where acceptable results have been achieved in important areas.

The UN Model, which is in general used by developing countries when negotiating double taxation conventions, also contains a "force of attraction" rule according to which business activities of the home office of the same or similar kind are automatically attributed to the permanent establishment. Switzerland is not in a position to agree to such an enlarged taxing right. The "force of attraction" principle can create difficult delimitation problems and thereby lead to juridical insecurity for the enterprises. It may also result in a nullification of the rules generally practiced in international tax law on the taxation of business profits.

b) Dividends, interest and royalties

In view of the one-sided economic and financial relations with industrialized countries, developing countries are in general not prepared to follow the withholding tax rates of the OECD Model, but ask instead for higher taxes in favour of the source country. Switzerland is prepared to provide for limited withholding taxes on dividends, interest and royalties and to grant a matching credit for withholding taxes on interest and royalties which, due to special domestic measures, have not been levied or are levied at a rate lower than the treaty rate. However, in spite of these concessions, the principle must be upheld that the taxing right is shared between the residence country and the source country which means that some tax revenue is left to the residence country after having granted the tax credit. Due to the relatively low tax burden in Switzerland, high taxes at source are the main obstacle for the conclusion of double taxation conventions. In case of intensive economic relations, there is a possibility to agree to withholding rates which exceed the ordinary Swiss treaty practice, but the tax credit must be limited to a portion of the withholding tax effectively levied – the exceeding part being only allowed as a deduction from taxable income.

c) Mutual assistance

In accordance with its policy in the field of exchange of information, Switzerland can only make provision for a mutual assistance clause in tax conventions with industrialized countries. Tax conventions with developing countries, therefore, do not contain an article on the exchange of information. However, the Swiss practice allows such an exchange to the extent the information is necessary for the correct application of a convention or for the prevention of its abuse. It is possible for Switzerland to confirm this practice through separate instruments.

In next issues:

Nigeria: The Sales Tax Decree 1986
by *J.M. Elegido*

Taiwan: The Value Added Tax Law in force
by *Jap Kim Siong*

Sri Lanka: Withholding tax on interest – Operation of the law
by *R.G.L. de Silva*

Taxation of rental property income in Burkina Faso
by *Lawrence A. Rupley*

A summary of Singapore's 1986 Budget
by *Lee Fook Hong*

Long-term fiscal policy 1985 – Its bearing on direct taxes in India
by *Parimal M. Parikh*

India: Measures against tax avoidance by multinationals
by *Har Govind*

OECD Report: International hiring-out of labor
by *Rykele Betten*

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

To facilitate ordering, a list of addresses of the main publishing houses is included on pages 43-44 of the January 1986 issue. Addresses of publishers which do not appear in this list are indicated in the item concerned.

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Africa

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CUMULATIVE INDEX 1986 – Nos. 1-5

Contents

of the July 1986 issue

INHALTSVERZEICHNIS

SOMMAIRE

Economic Analysis of Sales Taxation in India

By Dr. M. Govinda Rao and Dr. V.B. Tulasidhar*

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ABSTRACT

Sales tax has been the most important source of revenue for State Governments, ensuring their revenue productivity as well as a large degree of financial autonomy. But the growing pressure on resource mobilisation has led to several weaknesses in the structure of the tax. Preference for the first point levy and taxing inputs and outputs alike have escalated the cost structure through cascading. The complicated tax structure resulting from several tax rates, surcharges and additional turnover taxes, has opened up avenues of evasion and enhanced compliance costs. The operation of independent systems of sales tax in different States has caused wide differences in tax rates leading to significant resource misallocation. A form of tax competition practised by different States through sales tax incentives for industrialisation has led to enormous revenue loss with no tangible gain in terms of industrial growth. The taxation of inter-State trade has negated the economic advantages of the federation and contributed to inter-State inequity. It is hoped that the recognition of these economic ills would help in rationalising sales tax structures in the country.

I. INTRODUCTION

The seventh schedule to the Indian Constitution divides the tax powers between Central and State Governments. Accordingly, among the commodity taxes, while the Central Government is empowered to levy customs and excises, the responsibility of levying sales taxes is vested with the State Governments. Although the division of tax powers is unambiguous, in the legal sense, this has not avoided "vertical" and "horizontal" overlapping of the tax base. This, and the predominant emphasis on raising revenue rather than viewing the tax as an instrument to effect changes in resource allocation on desired lines has created problems in the achievement of both equity and efficiency. Several official committees and commissions as well as studies have examined in detail the structure and operation of sales taxes in various States and have recommended various measures to reform them.[1] As the States will be hard-pressed to raise more resources for the Seventh Five Year Plan (1985-90), sales tax is bound to be used as a crucial instrument in this respect. Unless the existing problems of the tax are well understood, employing sales tax as a major tax handle to mobilise resources is bound to create both allocative and distributive distortions. The purpose of this paper is to identify and highlight the major economic issues arising from the levy of sales tax in India.

Fiscal importance of the tax

The need to remedy the weaknesses of sales taxation assumes urgency in view of its prominent position in the Indian tax structure. Over the last thirty years it has emerged as the most important source of revenue to the States and its importance has been steadily growing. It accounted for only 9.21% of total tax revenue of the Centre and States together in 1950-51, but increased to 13.06% by 1964-65 and to 20.8% in 1982-83. In this process of mobilising revenues, it should be stressed that sales tax in India has been performing the important function of strengthening the federal structure by affording an increasing degree of financial autonomy to the States over the years. As a proportion of total tax revenue of the States, the yield of sales tax increased steadily from 37% in 1960-61 to 58% in 1982-83 (Table 1). Similarly, it could finance an increasingly larger proportion of revenue or current expenditures of the States, the proportion doubling from 14% in 1960-61 to 28.1% in 1982-83.

The fiscal importance of sales tax is seen not merely in the aggregate, but also in the case of individual States. Excepting in the case of Punjab and Haryana, revenue from sales tax constituted over 50% of the total tax revenues of States and, in 8 of the 15 States, the proportion was well over 60%. It may also be noted that it financed about a quarter of revenue expenditures in as many as 11 out of 15 major States. Further, in each of the States, over the years, sales tax revenue formed an increasing proportion of their tax revenue and financed successively higher proportion of their revenue expenditures.

* The authors are grateful to Amaresh Bagchi, Arindam Dasgupta, John F. Due, Sudipto Mundle and Mukul Asher, for comments on an earlier draft of the paper.

1. The important reports are India (1977), Kerala (1976), Gujarat (1980) and Uttar Pradesh (1980).

Table 1

Importance of sales tax in major States in India

Name of the State	1960-61			1970-71			1980-81			1982-83		
	Share in own tax revenue	Share in state domestic product	Share in expenditure within revenue account***	Share in own tax revenue	Share in state domestic product	Share in expenditure within revenue account	Share in own tax revenue	Share in state domestic product	Share in expenditure within revenue account	Share in own tax revenue	Share in state domestic product	Share in expenditure within revenue account
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)	(13)
Andhra Pradesh	30.30	1.24	15.40	36.67	1.98	19.14	48.49	4.05	24.31	50.27	NA	26.93
Assam	23.48	0.69	7.58	41.01	1.40	9.73	47.87	1.31	8.81	69.63	3.54	15.62
Bihar	32.85	1.06	16.00	48.17	1.70	16.32	70.07	3.02	20.87	69.14	3.62	19.44
Gujarat	50.67	1.43	20.78	59.06	2.92	30.93	66.64	5.76	39.17	66.05	6.54	39.28
Haryana	*	*	*	39.32	2.00	22.31	45.32	3.57	26.45	47.67	4.28	28.31
Karnataka	33.29	1.18	13.60	48.03	2.46	22.98	50.00	4.93	26.52	51.15	5.76	27.87
Kerala	44.72	2.09	20.06	57.59	2.98	23.50	60.60	5.86	30.55	62.78	NA	34.91
Madhya Pradesh	26.45	0.89	11.44	43.31	2.06	20.72	51.83	3.05	19.68	55.76	4.68	24.85
Maharashtra	50.05	2.01	27.42	62.62	4.13	36.94	66.32	5.37	39.00	62.32	6.31	39.07
Orissa	36.51	0.84	9.09	52.72	1.69	14.18	58.02	2.57	14.18	58.78	NA	12.38
Punjab	29.35**	1.85**	13.31**	43.34	2.60	31.47	44.70	3.41	28.38	44.84	3.66	32.28
Rajasthan	20.45	0.66	8.29	46.26	1.77	13.51	63.98	3.52	21.43	57.06	3.97	23.28
Tamil Nadu	45.68	1.72	21.17	54.99	3.45	28.32	71.92	7.99	39.89	64.80	NA	41.59
Uttar Pradesh	21.95	0.68	12.52	40.74	1.46	18.35	54.38	2.50	20.44	52.40	2.94	20.60
West Bengal	40.22	1.47	21.50	52.67	2.14	23.05	58.27	3.57	26.86	61.08	NA	24.03
All States	36.91	1.29	14.02	50.15	2.34	20.69	58.76	3.67	27.55	57.94	4.13	28.11

Notes:
* Haryana was bifurcated from the essential State of Punjab in 1965.
** Erstwhile Punjab included Haryana prior to 1965.
*** Revenue account corresponds closely to current account. The expenditure under this category are largely of recurring nature.
NA State Domestic Product figures are not available.

Source: Derived from Reserve Bank of India, Finance of State Governments, *Reserve Bank of India Bulletins*, (Relevant Issues).

Table 2

Buoyancy and elasticity of sales tax in major States (1971-72 to 1981-82)

State	Buoyancy	Elasticity	Buoyancy/ Elasticity
Andhra Pradesh	1.805	1.627	1.109
Assam	0.989	0.964	1.045
Bihar	1.722	1.538	1.120
Dehli	1.440	1.318	1.099
Gujarat	1.420	1.227	1.157
Haryana	1.505	1.362	1.105
Karnataka	1.821	1.492	1.086
Kerala	1.717	1.287	1.334
Madhya Pradesh	1.616	1.354	1.194
Maharashtra	1.267	1.153	1.099
Orissa	1.545	1.260	1.226
Punjab	1.389	1.033	1.345
Rajasthan	1.563	1.398	1.118
Tamil Nadu	1.785	1.627	1.097
Uttar Pradesh	1:563	1.382	1.131
West Bengal	1.651	1.354	1.219

Notes:
1. Buoyancy and elasticity coefficients have been estimated by regrassing the tax revenue series (actual and cleaned) on the SDP in the log-linear model. To estimate the clean series, the proportional-adjustment method has been followed.
2. All the coefficients are significant at 1% level.

Revenue productivity

In terms of fulfilling the objective of raising revenue, sales tax has been quite successful. The tax has been highly productive as the responsiveness of the tax with respect to gross national product (GNP) during the period from 1970-71 to 1981-82 was as high as 1.49 compared to 0.98 of non-corporate income tax, 1.21 of corporate income tax and 1.17 of Union excise duty.

The sales tax has been found to be a highly productive source of revenue in the case of individual States as well. The estimates for the period 1971-72 to 1981-82, summarised in Table 2, show that, excepting in the case of Assam, both buoyancy and elasticity estimates are found to be well above unity.[2] In 12 of the 15 major States, it had buoyancy values exceeding 1.5, with Karnataka showing the highest buoyancy of 1.82. The elasticity of sales tax was found to be the highest in Andhra Pradesh and Tamil Nadu (1.65).

Being the most productive revenue source for the State Governments, with growing pressure for resources, sales tax has come to be tapped to the utmost by all the State Governments. The ratios of buoyancy to elasticity in the case of all the Sates are found to be

2. "Buoyancy" and "elasticity" are the measures of aggregate and automatic responsiveness of the tax revenue to changes in incomes. Buoyancy represents the percentage change in tax revenue in response to a 1% change in State Domestic Product (SDP). Elasticity represents the percentage automatic change in tax revenue (netted for the revenue effects of discretionary measures) to a 1% change in SDP".

Table 3

Tax structure of various States

State	Single-point tax in a series of sales or purchase of, at the specified point of sale or purchase	Multi-point tax	Additional tax based on turnover	Surcharge	Tax at compounded rates
Andra Pradesh	Yes	Yes	Yes	Yes	No
Assam	Yes	No	No	No	No
Bihar	Yes	No	No	Yes	Yes
Gujarat	Yes	No	Yes	No	No
Haryana	Yes	No	No	No	No
Himachal Pradesh	Yes	No	No	Yes	No
Karnataka	Yes	Yes	Yes	Yes	Yes
Kerala	Yes	Yes	Yes	Yes	Yes
Madhya Pradesh	Yes	No	Yes	No	No
Maharashtra	Yes	No	Yes	No	No
Orissa	Yes	No	Yes	No	Yes
Punjab	Yes	No	No	No	No
Rajasthan	Yes	Yes	No	No	No
Tamil Nadu	Yes	Yes	Yes	Yes	Yes
Uttar Pradesh	Yes	No	Yes	No	No
West Bengal	Yes	Yes	Yes	No	No

Source: "Sales Tax Administration in India – As Seen in Audit", Comptroller and Auditor General of India, 1982.

Table 4

The number of tax rate categories in selected States

State	Number of tax rates	General rate of tax (%)
Andhra Pradesh	18	5*
Bihar	19	8
Gujarat	19	10
Haryana	7	7
Kerala	15	5*
Madhya Pradesh	13	10
Maharashtra	12	10
Orissa	6	8
Punjab	8	7
Rajasthan	15	8
Tamil Nadu	17	8
Uttar Pradesh	9	8
West Bengal	15	8

Note: * Multi-point.

Source: Sales Tax/Commercial Tax Departments of the State Governments.

greater than one and this indicates the substantial reliance on discretionary measures to mobilise resources through the sales tax. But, in their quest for revenue, the States have carried out drastic changes in the structure of the tax with little regard for considerations of economic efficiency or the consequence on equity.

The issues

In India, tax is leviable both on the sale or purchase of goods within a State as well as on inter-State sale of goods. While the levy of intra-State sales tax is entirely the prerogative of the State Governments, inter-State sales tax is levied by the States subject to the overall ceiling rate prescribed by the Central Government.[3] Over the years, with the States independently pursuing the main objective of raising revenue, different systems of sales taxation have been evolved in the country. Initially, three types of sales tax were levied: the single-point, the double-point and the multi-point, the last having the characteristics of a general turnover tax. The single point tax was levied either at the first point of sale – on the ex-factory price inclusive of excise duty – or at the last point of sale from a registered dealer. The double point sales tax prevailed mainly in the States of Maharashtra and Gujarat where on some commodities the tax was levied both at the first sale as well as at a semi-wholesale stage of sale. However, due to administrative considerations more and more commodities have been brought within the single stage – first point levy. Presently, excepting in a few southern States, namely Karnataka, Kerala, Tamil Nadu and Andhra Pradesh, which continue with multi-point tax on some commodities, single-point tax is in vogue (Table 3). Further, the revenue from the first-point levy forms an overwhelming proportion of the tax revenue in all the States.

In their anxiety to raise more and more resources to finance developmental plans, the States have introduced several ad hoc measures. Examples of such ad hoc discretionary measures can be clearly seen from the levy of additional turnover taxes and surcharges on sales taxes. These, once introduced as temporary measures, eventually become a permanent part of the tax structure. Of the 15 major States, it may be seen from Table 3, 10 levy the turnover tax, and the States of Andhra Pradesh, Karnataka, Kerala and Tamil Nadu levy surcharges on sales tax in addition to the turnover tax.

A distinctive feature of sales tax in India is that, unlike in most countries, it does not show the characteristics of a consumption tax for two reasons. First, the tax is not neutral between domestic production and imports. Taxation of imports is the prerogative of the Central Government, and as the sales tax is leviable by the States, imports are subjected to the tax only if they are resold by registered dealers. In many instances, capital goods and industrial inputs imported directly by the manufacturers are not subjected to the tax. As only the larger producers are able to get the required import

3. Over the years the ceiling rate has been revised upwards to raise more revenues. The current ceiling rate is 4% when goods are sold to registered dealers and 10% when sold to an unregistered dealer outside the State.

licences for importing these goods directly, it may be stated that the additional protection due to sales tax is largely confined to them. Second, as mentioned above, as the tax is collected predominantly at the point of manufacturing and import of goods into a State, all economic distortions associated with pre-retail sales taxes continue to pervade the tax structures.

It is necessary to highlight some of the other important features of the sales tax systems in the country which have important consequences on resource allocation and equity. First, a common feature of the sales tax systems in India is their complicated structures. Besides a list of exempted goods there exist a large number of rate categories in each of the States (Table 4), in some States numbering as many as 19. Second, with different lists of exemptions, differential nominal rate structures, differing incentive schemes for manufacturers and varying standards of administration and enforcement of the tax, the effective tax rates are widely different among the States. This has, besides causing trade diversion and resource misallocation, effected significant tax exportation (i.e. the shifting of the tax burden to the residents of other States) and the inequitable transfer of financial resources from richer to poorer States. Third, in principle, sales tax makes no distinction between consumer goods, inputs and capital goods, nor does it distinguish between sales to consumers and those to producers. In conjunction with the taxes on production (excise duty),[4] again on the inputs as well as outputs leviable by the Central Government and the tax on the entry of goods (octroi) leviable by the local Governments, the sales tax in India has generated a highly cascading and distorting type of indirect tax system which would have very few parallels. Fourth, the taxation of inter-State sales at as high a rate as 4%, has created, in effect, several tariff zones within the country and has greatly reduced the advantage of fiscal federalism, namely, a unified common market. This paper intends to analyse and identify the adverse economic consequences arising from the levy of sales tax in India. In Section II, we discuss the economic issues arising from the structure of sales taxes. The third Section deals with inter-State differentials in tax rates and its consequences on trade diversion and resource migration. The adverse economic consequences arising from the taxation of inter-State trade are discussed in the fourth Section. Section V provides the conclusions.

II. STRUCTURE OF SALES TAX IN INDIA: ECONOMIC ISSUES

In the evolution of the sales tax structures, raising of revenue seems to have been taken to be the main objective; efficiency in resource allocation and equity have received only secondary attention. It is, therefore, not surprising that administrative considerations have prevailed in determining the tax structure.

The general tendancy of the States to move towards the first point tax, widespread taxation of inputs and capital goods, imposition of ad hoc turnover tax and surcharge on sales tax, and persistance with multiple rate categories are only some instances of this.

The first point taxation: Economic ill effects versus administrative advantages

Almost all the States realise the bulk of their revenue from the tax at the first point. In the absence of setoff provisions, the first point tax in effect becomes a multistage levy, for it falls on successive stages of processing or manufacture of goods. Like Union excise duties, the manufacturers' sales tax leads to distortions in consumption patterns and resource allocation by imposing a lower burden of tax on commodities having high value added at wholesale and retail levels. As typically, post-manufacturing value added is low for items of common consumption and high for luxury goods, pre-retail sales tax tends to encourage the consumption of luxury goods. Besides causing inequity in consumption, this allocates scarce resources for the production of non-essential items (Lim, 1980). Pre-retail sales tax may even affect the method of doing business, as there is an incentive to pass on as much of the activity beyond the point of tax as possible. This also causes cascading wherein the price to the consumer increases by an amount larger than the tax imposed. Cascading is the highest with manufacturers' sales tax, where the goods which have borne the tax pass through the various stages of further processing and production (in the case of inputs) and distribution. In a situation of imperfect competition characterised by mark-up pricing, the larger the percentage of value added between the point of impact of the tax and final retail price, the higher would be the extent of mark-up and hence the escalation in the price due to cascading would be higher. The sizable difference between the producers' price and consumers' price in addition to the tax element, is appropriated by the traders. The extent of consumption distortion a pre-retail sales tax can bring about depends upon the extent of value added subsequent to the point of tax, degree of market imperfection and differences in demand elasticities.

The levy of first point sales tax has, however, a distinct administrative advantage. In developing countries such as India, administration of a retail sales tax is an onerous task because of the large informal sector consisting of numerous small scale dealers, many of whom operate without a fixed address and most of whom are not adequately educated to keep proper records. With the first point tax, however, a large proportion of the revenue can be collected from a small number of dealers[5] whose returns can be thoroughly scrutinised, while the returns of the smaller dealers can be summarily assessed. Thus, the cost of collection under the first

4. The excise duty, sales tax and octroi fall substantially on the same products. Unlike in many other countries, excise duty in India is not a sumptuary tax, but a broad based levy as almost all manufactured goods are taxable under the residual tariff item No. 67. Octroi, a local levy on the entry of goods into a local area, is a checkpost based tax.
5. To give a few examples, almost 80% of the tax is paid by 12% of the dealers in Gujarat, 6.5% in Madhya Pradesh, 6% in Karnataka and 10% in Uttar Pradesh.

point tax is lower, administration easier and enforcement more effective. It would thus seem that, in choosing the appropriate system of taxation, the economic advantages in having a retail sales tax have to be weighed against the administrative disadvantages.

Taxation of inputs and the problem of cascading

When sales taxes are levied on inputs as well as outputs, in addition to excise duties which again fall on both inputs and outputs, virtually two independent systems of sales tax at manufacturing level come into operation. The resulting cascading caused by the tax and the mark-up on tax produced by excise duty gets compounded with similar sales tax falling on the same products.

In the absence of detailed commodity level information it is not possible to quantify the extent of sales tax revenue collected from inputs and capital goods. However, from the information available for some of the States summarised in Table 5, we can form a broad judgement on the extent of cascading. It may be seen from the table that tax revenue from inputs and capital goods varies from 22% of total sales tax revenue in Karnataka to 39% in Tamil Nadu and Uttar Pradesh. The data collected by the Indirect Taxation Enquiry Committee (India, 1977) for the major States indicated that in 1974-75, almost 34.4% of sales tax revenue was collected from inputs and capital goods.

Cascading has harmful effects on the economy for several reasons. First, an increase in the consumer price by more than the tax element creates an additional dead-weight loss. Second, this adversely affects the competitiveness of Indian manufacturing because it is not feasible to arrange a duty draw-back of input taxes for the exported goods. Besides, designing the appropriate tax structure becomes extremely difficult as effective rates of taxation on final products cannot be easily estimated.[6] More importantly, cascading changes relative prices of commodities in unintended ways, because (i) rates of taxation of inputs are not uniform and (ii) input costs in the total value of a commodity (or the ratio of value added to total value) differ among commodities. Thus, the price escalation is higher for commodities having higher material input costs, lower non-material input costs (including wages) and lower value added, while the relative prices of commodities having a high component of value added in general, and higher value added in wholesale and retail stages in particular are reduced because of cascading. As these commodities typically are non-essential items, their consumption is encouraged and more resources are allocated for the production of these commodities.[7]

Complicated tax structures

Ad-hoc tax policies have complicated the tax structure in no small measure. The practice of levying across the board turnover tax, additional sales tax or a surcharge on sales tax by a number of States (Table 3) is one instance of such "ad-hocism". It is obvious that a proper redesign of the tax structure and recourse to selective discretionary measures are preferable for raising revenue.

Table 5

Sales tax on inputs (agricultural and industrial) and capital equipments

State	Year	Proportion of revenue from inputs and capital goods (%)
Gujarat	1977-78	33.6
Karnataka	1979-80	22.2
Madhya Pradesh	1982-83	39.3
Rajasthan	1982-83	23.8
Tamil Nadu	1979-80	38.7
Uttar Pradesh	1981-82	25.2
All India	1977-78	34.3

Source: Sales Tax/Commercial Tax Departments of State Governments.

Another factor complicating the tax structure is the multiplicity of tax rates (Table 4). This is attributable partly to administractors' preference for raising revenue in an ad-hoc manner and partly to the objective of making the structure more equitable. It may be noted that tax structures are not based on firm estimates of income and price elasticity of demand for different commodities but often on intuitive judgements. It would be incorrect to presume that a "smoothly" progressive system of taxation can be evolved in this fashion. It is therefore not surprising that in spite of according exemptions to a number of commodities judged to be basic necessities of life and highly differentiated tax rates, the distribution of tax burden is found to be only proportional (Ahmad and Stern, 1983). Perhaps it is possible to achieve better results on distribution with much less rate differentiation. Besides, under a simpler tax structure, compliance cost would be lower, administration easier and enforcement more effective.

Desirability of avoiding cascading sales tax

Considerations of both equity and economic efficiency suggest that it is desirable to evolve a tax system akin to the value added tax (VAT) with minimum rate differentiation. This would require that, gradually, the point of levy should be moved closer to consumption rather than production, the tax burden on inputs should be reduced and eventually removed altogether and rate differentiation minimised to ensure effective administration.

6. A recent study has attempted to estimate the effective tax rates. See Ahmed and Stern (1983).

7. By the same reasoning it may be argued that the cascading resulting from the prevailing sales tax system tends to encourage labour intensive methods of production, for, while wage costs are not subject to the tax, capital goods are taxable. But it may be preferable to encourage adoption of labour intensive methods through other measures rather than through cascading.

There can, however, be a discussion on whether the consumption type of VAT should be preferred to the GNP type. Under the GNP type of VAT, tax is leviable on all value added in addition to the value of capital goods sold (purchased) whereas, in the case of consumption type VAT capital goods are not taxed. The latter avoids all cascading and hence should be preferred. However, Due (1983) argues that a GNP type of VAT may be preferable in developing countries. This would at least partially offset the understated price of capital relative to labour arising from overvalued exchange rates and minimum wage legislation. In any case, it is important to note that, in the interest of economic efficiency, it is imperative to move away from the cascading type of sales taxation.

III. INTER–STATE DIFFERENTIALS IN TAX RATES: SOME IMPLICATIONS

Differences in effective rates of tax – why does it occur?

An important phenomenon observed in multi-level finance is the differentiation in tax rates for the same set of commodities across jurisdictions. Variations in effective tax rates among the States can arise essentially due to differences in (i) scope of exempted items, (ii) nominal tax rates, (iii) patterns of tax incentives for industrialisation and (iv) standards of administration and enforcement of the tax. Tax competition among the States is an important reason for the highly differentiated rate structure.

Exemptions from sales tax are accorded for reasons of equity, administrative convenience and as a tax harmonising device. Commodities considered to be basic necessities are exempted from the tax. Some products of the primary sector and perishables are not subjected to the tax due to administrative reasons. On three commodities, namely sugar, textiles, tobacco and its products, the States have surrendered the right to levy sales tax in lieu of the additional excise duty leviable by the Centre, basically as a tax harmonising measure. The differing notions on necessities (differing judgements on income elasticity of demand for goods), varying degrees of organisation of the economies of the States and hence the perception of administrative feasibility of taxing different goods are some of the important reasons for the differing exemption list.

Inter-State differences in nominal rates

Table 6 presents the comparative structure of nominal tax rates among different States for selected commodities. It may be seen from the table that both the point of levy as well as the rates of tax are widely different among the States. This may be partly attributed to varying notions of equity. What is disturbing, however, is the fact that one can also clearly discern the signs of tax competition from the variations in the rate structure. For example, generally, the food surplus States have higher rates of tax on cereals and pulses. Given that the demand for food imports is inelastic, the levy of higher tax rates on these items could clearly be a way of exporting the tax burden to the residents of importing States. Similarly, some industrially advanced States are known to collect a higher amount of revenue by keeping the rates of tax lower than their neighbouring States on manufactured goods which have income elastic demand. The absence of compulsion to raise resources for the Plan gives the Union Territories a clear edge in tax competition. Generally the lower effective rates of tax in Delhi on a number of manufactured goods and lower rates on truck and bus chassis in Goa, Daman and Diu are some cases in point.

Sales tax incentives for industrialisation

Another factor responsible for the differentiated effective rates among the States is the variety of sales tax incentives for manufacturers. The incentives usually take the form of lower tax rates on inputs, tax holidays or interest-free loans of the collected tax (Table 7). In some State limits are placed on the amount of incentives whereas in others it is open-ended. Again, the incentives may be across the board or selective to certain specified industries. Differentiation is also made depending on whether a manufacturing unit is located in a backward area or a more developed region.

As the output-linked incentives tend to reduce the cost of capital, this results in building excess capacity, particularly in industries having a low capital-output ratio which, typically, are the luxury consumer goods industries. Our analysis for Madhya Pradesh shows that, while the increase in investment or dispersal to backward areas owing to sales tax incentives cannot be considered significant, the exchequer had to forgo a significant amount of revenue, about 7 to 10% of the existing annual tax revenue collected by the State.

Further, when the present value of a future stream of benefits of tax incentives for the eligible period is estimated, it has been found that at full capacity output tax expenditure in relation to investment is extremely high in industries having a high output-capital ratio such as vegetable oil, veneer and plywood, liquid glucose, detergents, copper strips, asbestos cement pipes and LPG cylinders. In some cases, the tax expenditure even exceeded the amount of investment.

It is necessary to note that, in effect, when all States compete to attract investments they may merely be able to maintain their relative shares in capital investment and the resulting stock of capital investment in the States may not be very different from what would have been there had all the States avoided this form of tax competition. Such tax expenditures are expensive particularly to the poorer States which may have to forgo a substantial amount of tax revenue with no more tangible gain than being able to maintain the same level of investment. Given that the capital-output ratios differ among industries, sales tax incentives

Table 6

Comparative structure of sales tax rates in major States

	Andhra Pradesh	Bihar	Gujarat	Haryana	Karnataka	Kerala	Madhya Pradesh	Maharashtra	Orissa	Punjab	Rajasthan	Tamil Nadu	Uttar Pradesh	West Bengal	Dehli
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)	(13)	(14)	(15)	(16)
1. Cereals	2 to 4	3 to 4	E	4	2	1(a)	2.5 to 4	E	4	4	2 to 3	E	4	E(b)	E
2. Pulsees	4	4	E	4	2	4	4	E	4	4	4	4	4	E	E
3. Hydrogenated vegetable oil	4	9	4	7	6(f)	6	10	4	B	6	5	8	10	11	5
4. Edible oil (other than Hydrogenated oil)	6*	9*	4	6	2(f)	6	3	4	4	7	10	2(d)	4	8(d)*	5(f)
5. Cosmetics	5(d)	15	15	10	12(f)	16	13.5	15	16	10	10	12	12	11(d)	10(f)
6. Medicines and drugs	4	6	4	7	8	6	5	4	8	7	5	8	6	4	5
7. Stainless steel utensils	6	11	12	10	10	10	12	10	16	10	10	10	12	10	10(f)
8. Tyres and Tubes	6 to 10	10	6 to 12	10	10	9 to 10	6 to 10.5	7 to 12	12	10	10	10 to 15	8 to 10	10	10
9. Wooden furniture	5(d)	12	12	10	10(f)	10	8	12	12	10	10	8	12	8(d)	10(f)
10. Steel furniture	10	13	15	10	15(f)	12	12	15	16	10	12	15	12	15	10(f)
11. Refrigerator	13	16	15	10	15	15	13.5	16	16	10	10	15	10	11	10(f)
12. TV, VCR, Sterios, etc.	13	10	12	10	10 to 15	13 to 15	13.5	15	16	10	15	15	12	15	10(f)
13. Domestic electrical appliances	11	12	10	10	10	10	12	15	12	10	10	10	12	15	10
14. Motor cars	12	9	10	10	15	15	10.5	12	10	10	10	15	10	11	10(f)
15. Buses and trucks	12	9	12	10	6	15	10.5	12	10	10	10	15	10	11	10(f)
16. Non-electrical machinery	6	12	10(g)	10	8	8	10	10	8	10	8	8	6	8(d)	10(f)
17. Electrical motors	7	9	6	10	10	10	10	10	12	10	8	12	12	8(d)	10(f)
18. Other industrial machinery	6	NA	4	10	8(d)	8	10	10	12	10	8	8	6	8(d)	10(f)
19. Fertilizers	3	5	4	E	2	2	3	E	4	E	5	3.5	5	4	E
20. Cement	10	11	12	10	10(f)	8	10	8	10	8	8	12	8	8(d)	10
21. Metallic and non-metallic minerals	5(d)	4	10		5(d)	5(d)	10	10	12	7	4	5(d)	2	8(d)	7(f)
22. Goods not specified in sales tax schedule	5(d)	8	10	7	5(d)	5(d)	10	10	8	7	8	8	8	8	7(f)

Notes: (a) Some unspecified cereals are taxed at 4%.
(b) Rice and Paddy are taxed at 1%.
(d) Multi-point levy.
(e) Double-point levy.
(f) Last-point levy.
(g) Some specified types of machinery are taxed at a lower rate of 4%.
E Exempted from tax.
NA Not available.
* Some edible oils are taxed at a lower rate or exempted.

Source: Sales Tax/Commercial Tax Department of the State Government.

related only to the value of output favour those industries having higher value of output per unit of capital, which may not be the original intention.

Rate differences and trade diversion

An important economic consequence of tax rate differential is uneconomic trade diversion. Trade diversion from higher tax States to those where rates are lower can occur so long as the cost of transporting the goods is lower than the tax differential. Again, this can happen in respect of those commodities where the price differential between the States is due largely to tax differentials and not due to imperfections in the market. This happens mainly in the case of high value/low volume commodities produced largely in the manufacturing sector where the market imperfection is minimal.[8] Trade diversion not only affects the revenues of the States but can distort the tax structure itself. Sometimes, tax rates levied even on commodities having a

8. For example, the low rate of tax on bus and truck chassis in Silvasa (3%) in the Union Territory of Diu is said to affect the trade even in as distant a State as Uttar Pradesh. Similarly, the lower effective rates of tax prevalent in Delhi are believed to be a source of diversion of trade on a substantial scale from the States of Madhya Pradesh, Uttar Pradesh and Rajasthan, resulting in significant loss of revenue to them.

Table 7

Sales tax incentives for industrial units in different States

	Eligibility					Items			
	Sector	Size	Location	Duration years	Limit	Purchased	Sold	Exemption in the rate of tax	Remarks
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
Andhra Pradesh ST Loan	All except 67 industries	All	All areas except 33 major cities	5	10% of capital	Capital equipment raw material	Finished goods	Full	Repayable after 10 years
Bihar ST Exemption	All	NA	Backward areas	5-10	No limit	Raw material	Finished goods	Full	
Gujarat ST Exemption for New Units	All except 47 items	All	Backward areas	5-7	40% of the capital or Rs. 60 lakh to 50% of the capital or Rs. 80 lakh	Raw material purchased in the State	Finished goods	Full	
– for existing Units (expansion scheme)	-do-	-do-	-do-	-do-	35% of the capital or Rs. 50 lakh to 45% of the capital or Rs. 70 lakh	-do-	-do-	-do-	
ST Loan (as an alternative)	-do-	-do-	-do-	-do-	20% of the capital or Rs. 30 lakh to 35% of the capital or Rs. 50 lakh	-do-	-do-	-do-	Repayable after 12 years
Karnataka ST Exemption	All	Tiny	Backward areas	5	100% of the capital	-do-	-do-	-do-	
ST Loan	All	SSI	-do-	-do-	25% to 100% of the capital	-do-	-do-	-do-	Repayable in 10 instalments with an initial moratorium of 2 years
Kerala ST Loan	All	SSI	All	5-6	90% of the capital	–	-do-	-do-	
Deferment	All	All	All	1	Tax paid during the previous year	–	-do-	-do-	
Madhya Pradesh ST Exemption (new Unit)	Almost all industries	SSI	All areas	2-5	No limit	Raw material	Finished goods	Full	
	-do-	M&LSI	Backward areas	3-5	No limit	-do-	-do-	-do-	
ST Deferment (new Unit)	-do-	SSI	All areas	2-5	No limit	-do-	-do-	-do-	Repayable after 10 years
(Alternative to exemption scheme)	-do-	M&LSI	Backward areas	3-5	No limit	-do-	-do-	-do-	Repayable after 10 years
ST Deferment (existing units setting up new unit)	-do-	SSI	All		Rs. 4 to 12.5 lakh	Raw material	Finished goods	Full	Repayable after 10 years
Maharashtra ST Exemption	All	M&LSI and pioneer	Backward areas	3-9	75% to 90% of the fixed capital	NA	NA	Full	
ST Deferment	-do-	-do-	-do-	3-6	25% to 40% of fixed capital	NA	NA	-do-	
Orissa ST Exemption	All	Tiny & SSI	All	5		Machinery raw material etc.	NA	Full	
	All	SSI	All		10% of the capital or Rs. 1 lakh per year	-do-	NA	-do-	Repayable after 5 years
	All	M&LSI	All		10% of the capital or Rs. 25 lakh over 5 years	-do-	NA	-do-	Repayable after 10 years

	Eligibility					Items			
	Sector	Size	Location	Duration years	Limit	Purchased	Sold	Exemption in the rate of tax	Remarks
Rajasthan ST Exemption	Textilles, Cement, Mineral products, Engineering and Sugar	All	All	5	No limit	Raw material Machinery	Nil	Full	
Tamil Nadu ST Loan (New Units)	All	M&LSI	All	6	Tax paid in 4 years subject to a maximum of Rs. 20 to 100 lakh or 20% of the capital	All	All	Full	Repayable in annual instalment after 9 years
ST Loan (expansion schemes)	Textilles, Sugar, Cement, Minerals & alcohol are not eligible	-do-	Backward areas	6	Tax paid in years or 25% of new capital or	All	All	-do-	-do-
Uttar Pradesh ST Exemption	All	All	Backward areas	5-7	No limit	–	All goods	Full	
ST Deferment	All	Pioneer areas	–	–	-do-	–	-do-	-do-	
West Bengal ST Loan	Approved industries	All	All	5-7	5% of the fixed capital	Inputs	Outputs		Repayable after 10 years

Notes: SSI = Small Scale industries.
M&LSI = Medium and Large Scale Industries.
NA = Information not available.

Source: Sales Tax/Commercial Tax Department of Different State Governments.

very high income elasticity (such as motor cars) are lower than less income elastic commodities due to the fear of trade diversion.

A more serious adverse consequence of tax rate differences is resource misallocation. Significant differences in tax rates, ceteris paribus, may lead to migration of capital from high tax rate to low tax rate regions. This could not only result in cost escalations due to allocation of resources among States contrary to the resource endowments, but also may involve avoidable transportation of raw materials as well as finished products. The extent of allocative distortions, however, would depend upon the responsiveness of capital migration to tax rate differences in different activities.

Apart from the consequences on economic efficiency, differences in tax rates among the States can be a source of horizontal inequity. Broadly, if the tax differentials are equivalent to the differentials in public services, the fiscal residuum would be the same and (assuming that this is an appropriate measure) horizontal equity will not be violated. However, differential tax rates arising from the exportation and tax competition do violate the norms of horizontal equity. Further, in tax competition, economically advanced States fare better and are able to export a larger amount of tax to the less developed States for several reasons. These are explained in the following Section.

IV. ISSUES ARISING FROM TAXATION OF INTER-STATE TRADE

Central sales tax (CST) and inter-State exportation of tax burden

A special feature of the Indian sales tax system is the taxation of inter-State trade. Originally, the purpose of levying the tax was to "ensure that some revenue accrues to exporting States without raising unduly the burden on consumers in the importing State" (Government of India, 1977). Also, it was believed that a tax on inter-State trade could help to check evasion of taxes on inter-State trade sales. Considering, however, that this principle authorises a given State to tax citizens or other States, it was considered necessary to keep the rates low.

However, over time, the original purpose of inter-State sales tax was forgotten and raising of revenue became the main purpose. Though, initially, the Central Sales Tax (CST) was levied at only 1%, it has been raised by stages to 4%. This has created as many tariff zones within the country as there are States in the Indian Union.

Besides being a source of hindrance to the free flow of trade across State borders, the CST has become an important instrument of transfer of financial resources

Table 8

Share of Central sales tax in major States

Name of State	Growth rate of State Domestic Product from manufacturing 1960-61 to 1981-82	1960-61		1965-66		1970-71		1975-76		1980-81		1982-83	
		Revenue collection from CST (Rs. crore)	Share of the State (%)	Revenue from CST (Rs. crore)	Share of the State (%)	Revenue from CST (Rs. crore)	Share of the State (%)	Revenue from CST (Rs. crore)	Share of the State (%)	Revenue from CST (Rs. crore)	Share of the State (%)	Revenue from CST (Rs. crore)	Share of the State (%)
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)	(13)	(14)
Andhra Pradesh	13.06	0.44	1.91	1.11	1.58	3.62	2.46	24.39	6.51	33.13	4.60	66.39	6.19
Assam	NA	0.03	0.10	0.60	0.85	0.60	0.40	0.99	1.87	NA	NA	17.76	1.68
Bihar	9.80	2.68	11.63	6.11	8.67	9.98	6.78	14.20	3.79	21.92	3.04	51.01	4.82
Gujarat	12.27	0.88	3.82	4.72	6.70	12.90	8.76	33.53	8.95	92.40	12.83	111.12	10.51
Haryana	15.58*	–	–	–	–	6.73	4.57	18.22	4.86	NA	NA	61.22	5.79
Karnataka	12.11	0.63	2.73	1.67	2.37	5.91	4.01	23.05	6.15	46.61	4.47	73.62	6.96
Kerala	12.99	0.80	3.60	2.07	2.94	3.57	2.41	8.18	21.18	21.43	2.98	19.11	1.81
Madhya Pradesh	13.56	1.07	4.64	4.54	6.43	10.64	7.23	27.43	7.32	44.25	6.15	82.00	7.76
Maharashtra	12.55	4.88	21.14	15.34	21.77	37.43	25.43	85.98	22.95	198.37	26.30	233.13	22.06
Orissa	11.87	0.48	2.08	2.93	4.16	6.35	4.31	7.91	2.11	20.26	2.81	23.35	2.21
Punjab	16.77	1.35	5.86	4.43	6.29	8.82	5.99	17.00	4.54	34.14	4.74	42.96	4.06
Rajasthan	10.73	0.28	1.22	1.73	2.46	3.33	2.26	10.88	2.90	16.22	2.25	23.44	2.22
Tamil Nadu	11.82	2.28	9.90	7.15	10.15	13.79	9.37	33.27	8.88	65.59	11.89	101.59	9.61
Uttar Pradesh	12.93	0.88	3.82	2.03	2.88	5.01	3.40	16.58	4.42	28.19	3.92	52.27	4.95
West Bengal	9.23	5.81	25.22	16.06	22.79	25.25	17.15	46.81	12.49	85.39	11.86	120.35	11.39
TOTAL-ALL STATES		23.04	100.00	70.46	100.00	147.22	100.00	374.70	100.00	720.04	100.00	1056.98	100.00

Note: * 1965-66 to 1981-82

Source: *Reserve Bank of India Bulletin*, Relevant Issues.

from less developed to the relatively developed States. Export of taxable goods of industrially advanced States to industrially backward States exceeds their imports. As may be seen from Table 8, the four industrially advanced States of Gujarat, Maharashtra, Tamil Nadu and West Bengal collect over 52% of the CST revenues. In fact, the proportion of CST collected by some of the poorer mineral-producing States has been falling over the years, as has been the case with Bihar. Also, the States in which manufacturing sectors' SDP has been increasing at a faster rate have been enhancing their share of CST collections. Thus, the industrially advanced States manage to export a good part of their taxation to consumers in other States, the problem being further accentuated by the taxation of inputs. Sales tax on inputs escalates the final price of the commodity in an imperfect market situation characterised by mark-up pricing. Even in States where there is a provision of concessional taxation of inputs, this is applicable only when the final goods are consumed within the State and not when they are exported to other States. Thus, the effective rates on manufactured products would be much higher than those on raw materials and intermediate goods. Given that the proportion of finished manufactured goods in the total exports of industrially advanced States to backward States is higher than conversely, the extent of this perverse transfer would be greater than is reflected in the distribution of the CST alone.

It may, however, be argued that, like import duties providing protection to domestic industry, the levy of CST provides additional protection from competition to industries located within a State from those located beyond. This may, to some extent, help in the industrialisation of backward States. But the avoidance and evasion of the tax on inter-State trade is much easier than on inter-country trade and, consequently, the protection offered much less effective. Even if it is admitted that the CST helps the industrialisation of backward States, it should be noted that this is done at a very high resource cost to the economy. Perhaps a better method would be to provide a direct subsidy to neutralise cost disadvantages in backward regions and provide better educational facilities to develop skilled manpower at all levels and to develop the infrastructure of the backward States. In other words, expenditure, rather than tax policy, may be a better instrument in this regard.

Taxation of consignment transfers and implications for inter-State equity

Another adverse consequence of the high rate of inter-State sales tax has been its avoidance and evasion through consignment transfers. The high rate of tax had induced large manufacturers to establish warehouses in different States. Mere transfer of goods from the point of production to warehouses does not invite inter-State sales tax and thus provides an easy avenue of avoidance. It is the economy that eventually bears the burden of the additional cost of warehouses. Besides, the relatively large manufacturers are better placed to avoid the tax and thus gain an advantage over others.

With a view to checking this form of tax avoidance and to generate more revenue, the 46th Amendment to the Constitution was put through whereby consignment transfers can be subjected to tax. The decision to impose the tax is yet to be taken and in view of the pressing need to generate more revenue to bridge the resource gap for financing the Seventh Plan, this decision may indeed be taken soon. The Chief Ministers' Conference has already agreed to levy this tax at the same rate as the CST. The distribution of the proceeds inter-se States is to follow a formula whereby the States would receive 50% of the total collections on the basis of origin and the other 50% will be distributed according to the formula for distributing Union excise duties as decided by the Finance Commissions.

Two points need to be noted here. First, tax on inter-State trade or consignment transfers should not be looked upon as a "revenue" measure and the economic advantages of a federation should not be sacrificed by creating different tariff zones. Besides nullifying the advantage of a larger unified market, in the long run this may also have an adverse political repercussion on the federation. It should be noted that this, along with the tax on inputs prevailing in the States, generates inefficiency, affects competitiveness in manufacturing and leads to avoidable costs. More importantly, as argued earlier, it results in inequitable transfer of resources.

It may be argued that part distribution of consignment tax according to the Finance Commissions' formula would remove inequity from the levy. However, with the levy of consignment tax at a rate equal to inter-State sales tax, there would be no incentive for the manufacturers to indulge in consignment transfers at all. Presumably, with a tax on consignments, part, if not the entire amount, of such transactions will take the form of regular inter-State trade itself in order that the cost of building warehouses and branch offices in different States is saved, in which case the poorer States may not gain anything from the levy of consignment tax. Rather, consumers in the poorer States will have to pay a higher price for goods manufactured and brought from other States.

While it is necessary to tax consignments to prevent the avoidance of CST in the interest of economic growth, the rates of both CST and consignment tax should be kept at a low level. Further, ideally, the proceeds from both levies should accrue to the States not on the basis of origin but on the basis of consumption or at least according to the formula devised for distributing the consignment tax.

V. SUMMARY AND CONCLUSIONS

The excessive reliance on the sales tax for raising revenue in disregard of other economic objectives has, over the years, rendered the sales tax structure economically inefficient. Some of the ways in which it has caused distortions in allocative efficiency and equity in the country are summarised below:

(i) The administrators' preference for a first point tax has not only narrowed the tax base considerably, but also under imperfect market conditions, characterised by mark-up pricing, it has helped to escalate the cost structure through cascading. This cascading has been aggravated because the tax is levied both on inputs and outputs which are already subject to excise duties. Among other reasons, the significant dead-weight loss arising therefrom has only contributed to render Indian industries less competitive. Even the duty drawback for exported goods cannot be implemented effectively in the absence of a detailed knowledge about the extent of input taxation;

(ii) Enormous differences in the efffective rates of taxation arising from differing exemption lists, nominal rates and incentive schemes and varying degrees of administrative efficiency too, have affected the resource allocation in uneconomic ways. The tax competition has been no mean factor in causing variations in effective tax rates among the States. The extent of trade diversion and resource misallocation caused therefrom could be considerable. Further, in competing to export a portion of the tax to the residents of other States, the advanceda States have a clear advantage thus accentuating inter-State inequity; and

(iii) The taxation of inter-State sales on a significant scale, as at present in India, has only helped to create several tariff walls within the country and considerably reduce the advantages of a larger unified market. Besides, a peculiar type of protection from competition from other States is provided through the inter-State sales tax. This has become a device for the industrially more advanced States to pass on the tax burden to the residents of less advanced States. This has further escalated the inequitable transfer of resources.

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Taxation of Rental Property Income in Burkina Faso

By Lawrence A. Rupley[1]

Burkina Faso (formerly Upper Volta) is a land-locked Sahelian country of some six and one-half million people, bounded by Ivory Coast, Ghana and Togo in the south, Benin and Niger in the east, and Mali in the north and west. Burkina Faso was severely affected by the drought of 1982-84 as well as that of 1968-74. Agricultural development is severely constrained by desertification, land erosion, deforestation and a severe shortage of accessible water resources. Harvests were much improved in 1985, and the Government has made rural development/agriculture a major priority. The rate of inflation for the 12 months to September 1985 was 1%.*

*Abecor Country Report, "The Sahel", April 1986.

One major thrust of the Burkina Faso Government's fiscal system since the Conseil National de la Révolution under Captain Thomas Sankara came to power in August 1983 is to tax the income of the owners of rental real estate – houses and buildings – more heavily than hitherto. Such a measure has been introduced as a deliberate effort by the Government to combat what it regards as an excessive concentration of urban real estate ownership in the hands of a relatively small number of property owners. This tax should also serve to reduce the distance between the higher and lower ends of the income distribution.

For 1985, the effective tax rate on rental income was 100%, since all rents were required to be paid directly by tenants to the Government rather than to the owners of the rental properties. The owners eagerly awaited news of the policy for 1986! As of 1 January 1986 the rate of tax levied on rental income was revised, and such rates now range from 25% to 50% of such inçome:

Rates of tax levied on rental income as of 1.1.1986

Gross annual income arising from each building owned (CFA francs)	Percent of such income to be paid in tax
0 – 100,000	25%
100,001 – 300,000	30%
300,001 – 500,000	35%
500,001 – 800,000	40%
800;001 – 1,500,000	45%
Greater than 1,500,000	50%

Source: Burkina Faso, Kiti No. 86-002/CNR/PRES, 9 January 1986.

The CFA franc exchanges at a fixed rate of 50 CFA for one French franc. In May 1986, approximately 350 CFA francs equal one U.S. dollar.

The administration of this tax appears to have been carefully thought out and seems to work relatively well. The tenant makes his rent payment to the property owner who must then pay the tax to the Government. The property owner must then furnish to the tenant a photocopy of his receipt(s) for taxes paid. Starting in 1985, all rent contracts must be registered with the Government, and the tenant retains a copy of that contract. The tax authorities can therefore now ask the tenant to show the rent contract, the receipt for rent payments made by the tenant to the property owner, and the photocopy of the receipt for tax payments made by the owner to the Government. This system thus permits a cross-check of all three documents at one time. The tenant is, by definition, generally easier to locate in the vicinity of the property in question than is the owner who may live in a completely different area of town, or even in a different city. The tenant also has little reason to attempt to avoid compliance with the tax regulations and tax administrators. On the other hand, the property owner might be sorely tempted toward non-compliance if the tax system necessitated that he must be contacted directly as might be the case with a tax levied on the asset value of the property.

It has been suggested[2] that the increased rates of taxa-

[continued on page 309]

1. Dr. Rupley has worked in Nigeria and Kenya and now works in Burkina Faso and regularly provides commentaries on these countries.
2. Lyse Doucet, "Economics and Revolution", WEST AFRICA, 10 February 1986, 295 at 296.

NIGERIA:

The Sales Tax Decree 1986

By J.M. Elegido*

INTRODUCTION

Effective from 30 June 1986 a new Sales Tax Decree has been added to the Nigerian tax library. This is the first time that a uniform sales tax has been imposed in the country. Until now many states had enacted sales or purchase tax laws, but there were serious doubts about their constitutionality. Now all of these state taxes have been substituted by a uniform tax throughout the country.

THE SITUATION PRIOR TO THE SALES TAX DECREE 1986

Since 1979 more and more state governments have had recourse to the imposition of sales taxes in an attempt to increase their internally generated revenue. By 1986 12 out of the 19 states of the Federation had introduced some type of sales tax.[1]

The introduction of these sales taxes created some problems. First, it was not clear whether under the 1979 Constitution the states could validly impose sales taxes.[2] Secondly, some states levied the tax only "on goods brought into the state"[3] thus favouring "made in the state" goods over those manufactured in other states of the Federation. This appeared undesirable from the point of view of the Federation as a whole besides posing another constitutional question. Thirdly, the introduction of sales taxes increased the price of the taxed goods. This conflicted with the price control powers of the Federal Government and it raised both a policy problem and still one more constitutional issue. In fact the Productivity, Prices and Incomes Board[4] published a notice calling the attention of states wishing to introduce sales taxes to the fact that any such tax might infringe on the Board's guidelines on incomes and prices. Finally, the multiplicity of sales taxes with different states taxing different goods at different rates and following different administrative procedures created problems for companies operating throughout the Federation.

Eventually the Supreme Court had an opportunity to decide on some of these issues when giving judgement in the case *Attorney General of Ogun State v. Alhaji Ayinke Aberuogba and 6 others*.[5] The decision in this case can be summarized as follows:

(a) The Federation is entitled to levy sales tax on any saleable matter within its competence. A state can also do the same within its competence. However, it is not within the competence of a state:
  (1) to make sales tax law affecting any of the matters in the Exclusive Legislative List; or
  (2) to make any sales tax law affecting any of the matters in the Concurrent Legislative List which is inconsistent with any law validly made by the Federation; or
  (3) to make any sales tax law on any matter in the Concurrent Legislative List where any law validly made by the Federation has covered the field.

(b) The states can legislate on sales tax only if there is no Federal Law which controls the price of goods. A sales tax on goods which have had their price fixed by Federal Law, Order or Regulation is tantamount to a price increase and is therefore unconstitutional.

(c) Sales tax levied "on goods brought into the state" is unconstitutional on the grounds that it discriminates against inter-state or international trade and commerce which are within the exclusive regulatory power of the Federation.

(d) The Court supported the view of the Court of Appeal that sales tax on supply of services, e.g. in a hotel, is valid.

Many of the existing State Sales Tax Laws turned out to be totally or partially unconstitutional by the criteria set in this decision. Some offended by levying tax only on "goods brought into the state". Others taxed products such as petrol, diesel oil, petroleum products, beer, soft drinks or motor vehicles whose prices had been controlled by the Federal Government.[6] For the future it became practically impossible for the states that had not yet introduced the tax to do so without infringing on federal competences as a result of a Government Notice prohibiting any price increases without the consent of the Productivity, Prices and Incomes Board.[7]

The Federal Military Government has now tried to solve the above problems and remove areas of controversy by enacting a Federal decree on the subject. We will now proceed to examine the main provisions of this decree.

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1. These states are: Lagos, Ogun, Oyo, Ondo, Bendel, Anambra, Imo, Rivers, Cross River, Kaduna, Kano and Benue.
2. After the introduction of military rule in December 1983 it is no longer possible to challenge in any Court the validity of a Decree or Edict; S.5 Constitution (Suspension and Modification) Decree 1984. But the government obviously retains an interest in legislating in an orderly fashion and in framing the laws in such a way that they may survive after return to civilian rule.
3. E.g. Ogun State and Bendel State. See S.3(1) of the Ogun State Sales Tax Law 1982 and S.3(1) of Bendel Sales Tax Law 1982.
4. This is a body set up by the Productivity Prices and Incomes Board Act 1977 and charged – among other functions – with preparing guidelines on any question relating to incomes and prices.
5. (1985) 1 N.W.L.R. 395.
6. Schedule I to Price Control Act 1977. Price Control Commodities Order, No. 22 of 1979.
7. No. 67 of 1985.

TAXABLE GOODS AND SERVICES

Taxable goods are beer, wine, liquor and spirits, soft drinks, cigarettes and tobacco, jewels and jewellery, perfumes and cosmetics (excluding toiletries), video recorders, stereo sets, radios, television sets, video cassettes, cameras, airconditioners, fans, deep freezers, carpets and rugs (excluding linoleum) and bottled natural water. The services taxed are those rendered in registered hotels, motels, catering establishments, restaurants and other personal service establishments. The Sales Tax Committee, with the approval of the National Council of State,[8] may from time to time amend or vary this list of taxable goods and services. Any such amendment shall be published in the Gazette.

The Tax in respect of goods arises when the manufacturer or importer supplies such goods to its accredited distributors or agents. The tax in respect of services arises when a supplier supplies such services to consumers in the course of its business.

TAX RATES

The nominal tax rates are 5% of the price of the goods or services, with the exceptions of wine, liquor and spirits that are taxed at a 10% rate and beer and soft drinks (including mineral water) that suffer a tax of 36k and 24k per carton/crate respectively. But the reference price of the goods or services for the purpose of calculating the tax is fixed by the Sales Tax Committee with the approval of the Productivity, Prices and Incomes Board.

The rates of tax may be amended from time to time by the Sales Tax Committee with the approval of the National Council of State. Any such amendment shall be published in the Gazette.

THE SALES TAX COMMITEE

This committee is integrated by the chairman of the Joint Tax Board[9] as chairman, all members of the Joint Tax Board, one representative of the Productivity, Prices and Incomes Board, one representative of the Board of Customs and Excise, one representative of the Ministry of Commerce and the Legal Adviser to the Federal Board of Inland Revenue.

The main functions of this committee are to recommend changes in the taxable goods and services and in the tax rates to the National Council of State and to recommend changes in the reference prices of any taxable goods and services to the Productivity, Prices and Incomes Board.

This committee is subject to the control of the Minister of Finance in the performance of its functions.

COLLECTION AND PAYMENT

Manufacturers and importers are charged with the duty to collect to tax from their distributors or agents. In the case of taxable services the suppliers of these services shall collect the tax from their consumers. The tax must be collected not later than 30 days after the supply of any taxable goods or services.

The tax collected is payable to the Internal Revenue Department of the state where the distributor or agent of a manufacturer or importer of taxable goods or the supplier of taxable services carries on business. The tax must be paid to the appropriate Internal Revenue Department on or before the 30th day of the month next following that in which the tax is due. Each time a payment is made a return must be submitted in the form prescribed in Schedule 2 of the Decree and a copy of every return shall be forwarded to the Productivity, Prices and Incomes Board. The Joint Tax Board is vested with authority for resolving any conflict that may arise in the disbursement of revenue from the tax.

POWERS OF INSPECTION, OFFENCES AND PENALTIES

An Internal Revenue Department that is entitled to any payment of tax under the Decree has powers to start an investigation either by itself or by authorizing in writing any person to act on its behalf. The powers of the person conducting an investigation are broad and include requiring any manufacturer, importer or supplier to produce any books, documents or records relating to taxable goods or services, to make copies of them and to demand any other information or assistance that in its opinion would assist in the inspection. A person conducting an inspection can also enter the premises of any manufacturer, importer or supplier and remove any books, documents or records relating to taxable goods or services where he/she has reason to suspect that the Decree is being contravened.

Any delay in delivering to the appropriate Internal Revenue Department tax already collected will attract a penalty of 5% of the tax.

Failure to comply with any provision of the Decree or to pay an amount collected plus penalty within two months of its being demanded constitutes an offence. When an offence is committed by a body corporate a firm or an association of individuals, every director, manager, secretary or similar officer of the body corporate, or partner or officer of the firm or person

[continued on page 334]

8. The National Council of State is made up of the President, the Chiefs of Staff, Supreme Headquarters, the Minister of Defence, The Attorney General of the Federation, the Inspector General of Police and all the Military Governors of the states: S.9 Constitution (Suspension and Modification) Decree 1984.
9. The Joint Tax Board was established by the Income Tax Management Act 1961. Its membership consists of the Chairman of the Federal Board of Inland Revenue, one representative of each state, usually the chairman or director of the respective Board of Internal Revenue or equivalent body, and a secretary that is not a member. Its main functions are to advise the Federal Government in respect of taxation matters having effect throughout Nigeria and promote uniformity in the application of tax laws throughout Nigeria.

INDIA:

Measures against Tax Avoidance by Multinationals

By Har Govind

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INTRODUCTION

The term "multinational corporation" (MNC) became universally well-known after the publication of Report No. E 73 AII titled "Multinational Corporations in World Development" issued by the Department of Economic and Social Affairs of the United Nations Secretariat. This Report was prepared in pursuance of Resolution No. 1721 (L III) of 28 July 1972 which was unanimously adopted by the United Nations Economic and Social Council. In this Report, the expression "MNC" has been used, generally, to cover international, multinational, transnational, supranational and global corporations. Broadly speaking, there are three kinds of MNCs, as summarized below:

(a) *Transnational*
A transnational corporation is "solely geographic". It remains attached to a particular country despite the installation of its machinery of production or distribution in several countries. It is a national company with global extensions.

(b) *Multi-origin*
A corporation may be multinational in origin with respect to the capital at its disposal or the capital resources of the directors. The corporate structure may be such that it may not be possible to connect it with any particular country. Two well-known instances of such corporations are Royal Dutch Shell and Unilever.

(c) *Intermediate type*
A corporation which retains its principal national identity while engaging in joint ventures, either with investors of local capital or other participants in other countries, is of a type which is intermediate between (a) and (b).

The tax treatment of multinationals in India has three important aspects:

(a) the taxation of foreign companies;
(b) measures against tax avoidance by multinationals;
(c) the tax treatment of resident taxpayers on payments made by them to foreign companies.

For a general background study, see "India: Taxation of Foreign Companies" published in the *Bulletin*, December 1984 (Volume 38 No. 12).

CONCEPT OF FOREIGN COMPANY

A foreign company under Section 591 of the Indian Companies Act 1956 broadly means a company incorporated outside India which has a place of business in India. The concept of a foreign company under the Income-tax Act 1961 (IT Act) is somewhat different. For tax purposes, companies are characterized as domestic and non-domestic. A domestic company means a company registered in India. It also means a company which is not registered in India but which has made prescribed arrangements for the declaration and payment of dividends in India in respect of income subject to Indian tax. As a consequence, in addition to its profits, dividends declared by such a company also become subject to Indian tax in respect of all shareholders whether or not they are resident in India. In this manner, a company can elect to be considered a domestic company although it is registered outside of India. Therefore, for tax purposes, a foreign company means a non-domestic company. Separate statistics on such companies are not available. Their approximate number, however, can be estimated from the number of foreign companies, as defined under Section 591 of the Companies Act, doing business in India.

Table I

As at 31 March	*Number of foreign companies*
1977	482
1978	473
1979	358
1980	315
1981	300
1982	311
1983	320
1984	326

Source: Report for the year ending 31 March 1984 of the Department of Company Affairs, Government of India.

Of the 326 foreign companies reported on 31 March 1984, a majority were from the United Kingdom (128) and the United States (68).

An Indian subsidiary of a foreign company is considered an Indian company. It is a separate legal and assessable entity from the holding company. It is not treated as a foreign company for tax purposes. It will be noted from the above Table that the number of foreign companies in 1984 is smaller as compared to in 1977. This is due to the fact that foreign companies are gradually converting themselves into Indian companies due to a Government indigenization policy and also to qualify for greater tax benefits under the IT Act.

MULTINATIONALS – GENERAL IMAGE

Most of the foreign companies operating in India are multinational corporations. In certain interested quarters, MNC is a "dirty word". But this is not a balanced view. In the Indian situation, the image of MNCs is bright in some parts and shady in others. They do have some specific factors in their favour: the quality of their management is high; they have brought new and useful management concepts to the country; they pay better wages and follow better labour practices; in general, the safety standards adopted by them are good;[1] multinationals have a good record of pollution control and environmental management; and, finally, the quality of their product is reliable. This is the general picture. Undoubtedly, there are a few MNCs which fail to conform to this picture and the record of some Indian concerns can be not only as good but superior to some of the MNCs operating in India.

On the negative side, it has been alleged that MNCs charge high prices, follow unfair pricing policies in respect of imports and exports, adopt obsolete technology, charge repetitive payments for the same technology, dump drugs and other products which are banned elsewhere in India, avoid tax on a global scale, and, overtly or covertly, interfere in the internal affairs of the host country.

These last allegations regarding the negative and harmful role of MNCs need to be tackled by various methods including administrative and fiscal measures. This article focuses on methods practised by multinationals to avoid taxes and on measures which have been adopted or should be adopted to combat such tax avoidance practices.

Tax evasion techniques

Tax evasion or avoidance is very frequently indulged in by foreign companies which take advantage of the fact that their books are maintained at their head office and are therefore not available for examination by the assessing officers of the host country. This underscores the practical and administrative difficulties often countered when dealing with the assessment of multinationals.

Some specific practices of tax evasion by multinational corporations have come to light during the past years. They are briefly listed here for ready recapitulation:

- price manipulation;
- inflation of interest and rent;
- duplicate payment for management charges;
- payments for non-existent services;
- collusive agreements to shift income source;
- disguising royalties as management charges;
- allocation of expenses not connected with business;
- disproportionate allocation of head office expenditure;
- disguised dividends through loans.

The broad technique of a multinational corporation to evade proper taxes or to reduce its overall tax burden is to transfer its income from a country of high tax incidence to a tax haven country or to a low tax jurisdiction. Sometimes, the transfer of income from one country to another is also done to circumvent foreign exchange regulations. The transfer of income is effected through one or more of the above methods. The manipulated channelling of income distorts equitable allocation of income and adversely affects the tax revenues of the source country. It also makes a sizeable dent in the foreign exchange position. Developing countries like India can ill afford such a drain on their tax and foreign exchange resources. In this context, it will be useful to study the preventive provisions incorporated in the Indian Income-tax Act. This study should also help in comprehending the problem as it arises in the entire arena of third world countries.

Collusive invoicing

Multinational corporations sell or transfer goods, products and services to their marketing branches, subsidiaries, or associates at prices based not at the market rate but at rates fixed by themselves. There is every possibility of price manipulations through transfer pricing in such transactions to the detriment of the host country. While the price of imports is inflated, that of exports is deflated. A specific example may be cited from a working paper prepared by two researchers of the Indian Institute of Public Administration, New Delhi. In their study "Multinational Corporations and Self-Reliance – A case study of drugs and pharmaceuticals in India", Naresh Kumar and K.M. Chenoy have noted that an export-oriented pharmaceutical concern having 49% foreign equity was exporting drugs to its parent company at prices that were so low that it would have been operating at a loss but for export subsidies provided by the Government. There are, of course, many other examples of drug and other multinational corporations avoiding taxes in India and other countries.

Use of tax haven countries

There are many instances where multinational companies channel their profits to subsidiaries or associates located in tax haven countries through deflated pricing. A multinational corporation, having a

1. The widely reported leakage of poisonous gas at the Union Carbide Factory at Bhopal in Madhya Pradesh in December 1984 which killed many people should be treated as an isolated example.

manufacturing or purchasing subsidiary or associate in one country, may float a marketing agency or subsidiary or associate in a tax haven country. The goods manufactured or purchased are sold to a third party in another country. The transactions are carefully arranged so that on the instructions and account of the subsidiary in the tax haven country, the subsidiary in the exporting country exports goods to the third party and debits the subsidiary in the tax haven country at less than the fair market price. The subsidiary in the tax haven country would charge the third party at the real market price and pocket the difference. Very little would have been done by the enterprise in the tax haven country by way of market exploration or any other work to justify taking such a large part of the profit. Normally, it would be difficult for the tax authorities of the exporting country to find out whether the export price is a fair market price for the goods. If such transaction is sought to put through a tax haven enterprise, a provision has to be made regarding the transfer price. However, in some cases, the prices of exported goods are declared in the bills of lading by the exporting enterprise, not at the prices which it charges its subsidiary but at the prices which the subsidiary would charge the third party. Examination of the bills of lading may, therefore, reveal the actual prices charged to third parties for these goods.

To avoid arousing the suspicions of the tax authorities in the country in which it operates, a multinational corporation may evade tax by transferring its income from that country to a foreign country through a non-associate third party in that foreign country. This may be done by under-invoicing its exports to and over-invoicing its imports from those parties in the foreign country, and by arranging to pay the differences between the invoiced amounts and the actually agreed upon amounts for the goods to an associate, subsidiary or nominee in that foreign country as payment towards commissions due to them. Over-invoicing of imports may even be done in respect of capital goods such as machinery since the depreciation allowance is granted on the cost of imported plant and machinery.

Inflation of interest and rent

Some foreign companies have been observed paying rent and interest to their head office or overseas associates at inflated rates. For instance, some foreign banks in India were found paying interest to their head office or overseas branches at rates which were higher than the rate of interest received by them. The problem of determining the fair rate of interest and rental is not difficult. International rates are normally available for comparison and they can be used in appropriate cases to disallow the excess payment.

Duplicate payment of management fees

It is the general practice of a parent company or of a foreign associate, in billing for goods or products supplied to an Indian branch, subsidiary or associate, to include expenses for management in the price. However, it has been found that the Indian branch, subsidiary or associate further debits management charges. There is hardly any justification for this duplicate charge. If the price does not include management fees, then the full particulars of the services rendered must be obtained to evaluate the reasonableness of the charges. The place where the services are rendered should also be ascertained. If the services are rendered in India, the management fees, subject to any double tax agreement, will be taxable in India in the hands of the foreign parent or associate company.

Payment for non-existent services

It came to notice that sterling tea companies operating in India deducted for commissions paid to their overseas Secretaries on sales of tea made not only in the United Kingdom and other foreign countries but also on sales effected in India. On scrutiny and verification, it was discovered that no services were rendered by the U.K. Secretaries to the tea estates in India. These instances highlight the need for adequate verification when allowing such claims of deduction.

Agreements to shift source of income

As foreign-source income of a non-resident is not taxable in the host country, attempts are made to claim host country income as home country income. To plug such tax loopholes, the Income-tax Act provides elaborate source rules for all income in general and for income from royalties, technical fees, dividends and interest derived by foreign companies. For a detailed description and analysis of these source rules, see "Taxation of Foreign Companies in India" in the December 1984 issue of the *Bulletin*.

Commutation of income from dividends, royalties, technical fees and interest

Before certain dates indicated in Table II below, taxable income from dividends, royalties, technical fees and interest was determined on a net basis, that is, after allowing deductions for costs and expenses incurred in earning the income. A new Section 44D and amended provisions of Sections 57 and 58 introduced special rules for computing income earned from these four sources by foreign companies from Indian concerns. The existing provisions are summarized in the Annex.

Royalty disguised as management fees

The source of income by way of management charges is normally the country in which the services are rendered. The source of royalties is the country in which the relevant patents or trademarks or technical know-how are used or are to be used under the royalty agreement. Royalties are normally subject to deduction at source. Management fees are also subject to deduction at source if they are in respect of services rendered in the country in which the enterprise paying the charges is located. It has come to light that what are actually royalty payments to their parent companies, are described by some subsidiaries of multinationals as management charges for services rendered outside the country. An examination of the agreement for payment of these so-called management fees and an inquiry into the particulars of the services rendered showed that major portions of the payments were in the nature of royalty payments and only small portions could at best be said to have been towards management charges for services rendered outside India. When the facts were properly compiled and presented, the subsidiaries agreed that the payments were in fact royalties and paid the tax, accordingly.

Head office expenditure

Some cases came to the notice of the Income-tax Department in which the head office expenses of foreign companies allocable to their Indian branches were inflated to artificially reduce taxable income in India. Such manipulations were practised by foreign companies from countries where the rates of tax were lower than those in India. Some foreign concerns indulged in this practice to further their own interest by securing remittance of larger funds from India to their own countries. Thus, excessive claims on account of head office expenses not only caused loss in terms of revenue to the Indian exchequer but they also constituted a significant drain on its foreign exchange resources.

In its 176th Report, the Public Accounts Committee of Parliament mentions the following case concerning a foreign bank. A claim of Rs. 10.5 million on account of head office expenses was investigated in depth by the Tax Department in the bank's assessment year 1971-72 and a sum of Rs. 3,620,000 was disallowed. Though the bank appealed the assessment, it did not dispute the disallowance of head office expenses amounting to Rs. 3,492,000. After considering the action taken by the Government, the Public Accounts Committee observed in its 192nd Report that there was no effective machinery in the Income-tax Department to check the genuineness of expenditure incurred outside India. Remedial action was, therefore, necessary to rectify this deficiency. As the issue was vital both in terms of taxation and foreign exchange, the Committee also suggested a review of the working of the organizational machinery dealing with the taxation of foreign concerns.

Disguised dividends

The present definition of a dividend in Section 2(22)(2) of the Income-tax Act evolved over a period of more than four decades. In addition to dividend in the ordinary commercial sense, the term "dividend" also includes any payment by a closely-held company by way of advance or loan to a shareholder having substantial interest in the company or any payment by such a company for the benefit of such shareholder.

The above definition of dividend has come to its present stage after a ding-dong contest between the tax planner and tax collector.

The definition of "dividend" in Section 2(22) has reasonably stabilized after several amendments and some rulings of the Supreme Court. It has been held by the Supreme Court in the case of *Navnitial Javeri v. K.K. Sen* (1965), 56 *Income-tax Reports* ITR 198 that the Parliament of India was competent to enact such a provision. It neither violates Article 14 of the Constitution which guarantees equality before the law nor Article 19 of the Constitution which protects six "fundamental freedoms" including the freedom to carry on any occupation, trade or business. Substantial shareholders of closely-held companies are, therefore, expected to be conscious of the deterrent provisions contained in Section 2(22)(2).

Upstream loan

The normal route of investment of funds is from a parent or holding company to its subsidiary. A loan is "upstream" when it flows from the subsidiary to the parent. Very often the subsidiary and the parent companies are carrying on business in the same country. If the holding company is an MNC, it may have subsidiaries in one or more of the less developed countries (LDCs). The present provisions in the Companies Act place only some regulatory limits and restrictions on inter-company loans. There is no total ban on such loans. Further, the constrains do not apply to private companies. Under the Companies Act there is no right to a dividend unless it is declared in a general meeting (*Mathai Chandy v. Hill and Transport Union Ltd.* (1955), *ILR* Trav. 73). A loan by a company to another cannot be treated as a dividend under the Companies Act. An inter-company loan also does not come within the ordinary meaning of the term "dividend".

Sidestream loan

An upstream loan can also take a "sidestream" route. A loan may flow from one third-world subsidiary through another third-world subsidiary to, for instance, a British subsidiary. The parent of all three subsidiaries may be an American or other developed country multinational company. The parent may remain unnoticed in the fiscal regulations of all three host countries.

PROVISIONS AGAINST TAX AVOIDANCE IN INDIAN LAW

Transfer pricing

Where agreements for the avoidance of double taxation are in operation, they generally provide that profits should be determined on an arm's length basis. In other words, the transactions between the parent company and its branches, subsidiaties and associations should be charged at prevailing market prices. Where there is no tax treaty, the tax laws of many developing countries contain appropriate provisions. In India, Section 92 of the Income-tax Act gives the Income-tax Officer the power to determine the reasonable amount of profit accruing or arising in India if it appears that a resident has transferred his Indian-source income to a closely connected non-resident by collusive invoicing or any other arrangement in the course of any business transacted between them.

It is not easy to determine the comparable market price for goods and services in the case of many MNCs. Firstly, the price in the domestic market may not be comparable with the price in the export market as both these markets are insulated by tariffs. Secondly, the market price in one foreign country may not be comparable with the price in another foreign country and companies charge prices on the basis of what each market can bear. Thirdly, the goods produced by many of these corporations are marketed under their trademarks and a company may claim that its product is different from that of a rival and therefore there can be no basis for comparison. Lastly, information as to how much profit is made on the sale of the transformed goods may not be available when assessing the reasonableness of the allocation of the income to the transferor. However, in spite of such limitations, the fair market price of goods may be determined by one or more of the following methods:

(a) comparing the transfer price with prevailing market prices, after making suitable adjustments for quality, quantity, time of sale, and other relevant factors;
(b) in the case of purchase by a marketing concern, applying an appropriate mark-up factor downwards to the resale price to outside parties, namely, to the price at which the goods are sold by that enterprise to non-associate third parties;
(c) in the case of a manufacturing or buying concern, estimating a reasonable mark-up on the cost and adding it to the cost;
(d) comparing the price with the value taken for the goods by the customs authorities for purposes of the levy and collection of customs duties;
(e) comparing the price with the value taken for purposes of insurance.

Agreements to shift source of income

An important principle grafted to the source rule is the concept of deemed income. In addition to income actually accruing or arising in India, income deemed to accrue or arise in India is also taxable under Section 9 of the Income-tax Act. Deemed income is income which accrues or arises directly or indirectly:

(a) through or from a business connection in India;
(b) through or from any property or any asset or source of income in India; or
(c) as payment for services rendered in India.

The term "business connection" has been the subject of considerable litigation and there is a catena of case law relating to it. However, it will be sufficient to mention one important leading case here. In *CIT v. R.D. Aggarwal & Co.* (1965); 56 *ITR* 20 (SC), the Supreme Court observed that a "business connection" involves a relation between a business carried on by a non-resident which yields profits and gains and some activity in India which contributes directly or indirectly to the earning of those profits or gains. It predicates an element of continuity between the business of the non-resident and the activity in India. An isolated transaction is normally not regarded as a "business connection". There are, however, some exceptions to the above general rules.

Head office expenditure

It proved extremely difficult to scrutinize and verify claims in respect of head office expenses, particularly in the absence of books of accounts of the head office which are kept outside India. To overcome these difficulties and to reduce the incidence of tax avoidance, the Finance Act 1976 has added a new Section 44C to the Income-tax Act. Under this Section, the expression "head office expenditure" must be taken to mean executive and general administration expenses incurred by the assessee outside India. Section 44C lays down a ceiling of admissable head office expenditure. The limits prescribed are as follows:

(a) an amount equal to 5% of the "adjusted total income" of the assessee for the relevant year;
(b) an amount equal to the average head office expenditure allowed during the base period of 3 years, namely, the previous years relevant to the assessment years, 1974-75 to 1976-77;
(c) an amount of so much of the expenditure in the nature of head office expenses which are incurred by the assessee which is attributable to the business of profession of the assessee in India.

The limit up to which the deduction is permissible to the assessee is the lesser of these three amounts. If, however, the actual amount on account of head office expenses claimed by the assessee is less than the limits specified above the deduction admissible would be confined to the amount of actual expenditure.

The Reserve Bank of India has also evolved a new procedure. It will not allow any remittance on account of head office expenses to be made separately. If after completion of the income tax assessment, the foreign company requests a remittance on account of head office expenses, such remittance may be allowed only on production of the income tax assessment order indicating the amount of head office expenses payable. For facility of ready reference, a foreign company should request its Income-tax Officer to clearly mention in the assessment order the amount of head office expenses allowed along with the total tax payable.

Upstream loans

Section 2(22)(2) of the Income-tax Act provides that, where a company pays any sum, by way of advance or loan to another company, it would be treated as a dividend and taxed in the hands of the latter provided that:

(a) the lending company is one in which the public is not substantially interested within the meaning of Section 2(18) of the Income-tax Act (in other words, it must be a closely-held company);
(b) the borrowing company has substantial interest in the lending company, that is, where at least 20% of the shares carrying voting power are registered in the name of the borrowing company; and
(c) the lending company possesses accumulated profits at the time of making the loan and the payment of the loan is deemed to have been made to the extent of such profits. Accumulated profits include general reserves, surplus in the profit and loss account, and development reserves like investment allowance reserves but does not include non-taxable capital gains.

The above analysis shows that an advance or loan by a widely-held company to another company cannot be treated as a deemed dividend within the meaning of Section 2(22)(2). Only an advance or loan by a closely-held company to another company where the borrower company has a substantial interest in the lending company can be deemed a disguised dividend and treated under Section 2(22)(2).

Treatment of upstream loans in the United Kingdom

In the United Kingdom, loans to MNCs from their subsidiaries in less-developed countries have come to adverse notice. According to British tax authorities, such receipts of upstream loans are nothing short of disguised dividends. Although parent companies pay interest to the subsidiaries on upstream loans, this is a tax avoidance measure because interest on upstream loans, being expenditure reduces taxable profits and, therefore, the parent companies' corporation tax liability in the U.K.

Sidestream loans

The Indian Income-tax Act is somewhat ahead of its U.K. counterpart in bringing into the tax net disguised dividends in the form of upstream loans by closely-held subsidiaries. However, a careful reading of Section 2(22)(2) Income-tax Act in the light of judicial decisions, shows that a sidestream loan does not fall within the deeming provisions of Section 2(22)(2). Firstly, Section 2(22)(2) explicitly applies to only direct payments. It does not cover an indirect disbursement. Secondly, it has been held by the Supreme Court in the case of *Rameshwarlal Sanwermal* (1980), 122 *ITR* 1 (SC) that a deemed dividend within the meaning of Section 2(6A)(e) of the Income-tax Act 1922 corresponding to Section 2(22)(2) of the 1961 Act is taxable only in the hands of the registered shareholder and not the beneficial shareholder. Thus, if a parent company takes the loan through a branch or through a company which has no substantial interest in the lending company, the loan though nothing short of a disguised dividend will not be hit by the provisions of Section 2(22) which does not cover an indirect or sidestream transaction.

PENALTIES AND PROSECUTIONS

The IT Act provides various deterrent penalties and punishments for the concealment of taxable income. These provisions broadly apply to all taxpayers, except that non-resident individuals or directors of foreign companies cannot be sentenced to prison terms if they are not stationed in India and do not visit the country. It will be useful to make a brief note of the provisions relating to penalties and prosecutions.

Penalties

Section 271(1)(c) of the IT Act provides that if the Income-tax Officer, during the course of any proceedings, is satisfied that any taxpayer has concealed or furnished inaccurate particulars of its income, he may direct that such taxpayer shall pay a penalty. The minimum amount of such penalty shall be equal to the amount of tax sought to be evaded. The maximum amount of such penalty may be as high as twice that amount. As a measure of administrative safeguard, the Act lays down that if the penalty exceeds Rs. 25,000 the Income-tax Officer shall pass the penalty order only after obtaining the prior approval of his superior officer, namely the Inspecting Assistant Commissioner of Income-taxes.

Prosecution

Section 276C of the IT Act provides that if a taxpayer willfully attempts, in any manner whatsoever, to evade any tax chargeable or imposable under the Act, he shall, without prejudice to any penalty that may be imposable under Section 271(1)(c), be punishable with a fine and:

(a) in a case where the amount sought to be evaded exceeds Rs. 100,000, with rigorous imprisonment for a term which shall not be less than 6 months but which may extend to 7 years;
(b) in any other case, with rigorous imprisonment for a term which shall not be less than 3 months but which may extend to 3 years.

Section 278B provides that if the offence under this Act is committed by a company, every person who, at the time of the commission of the offence, was in charge of and was responsible to the company for the conduct of its business, as well as the company itself shall be deemed to be guilty of the offence and shall be liable to prosecution and penalty. The person concerned can, however, claim immunity from prosecution by proving that the offence was committed without his knowledge or that he had exercised due diligence to prevent its commission.

Section 279 provides that the prosecution is to be at the instance of the Commissioner. The Commissioner has authority either before or after the institution of prosecution proceedings to compound the offence by charging a compounding fine or to drop the prosecution proceedings.

Powers of discovery

Apart from audits and the scrutiny of accounts, the income tax authorities have powers of search and seizure. Section 132 of the IT Act gives powers to certain tax authorities to enter and search any building, place, vessel, vehicle or aircraft where they reasonably suspect that some undisclosed books of account, other documents, money, bullion, jewellery or other valuable articles are kept. They can seize them or place marks of identification on any books of account or other documents. A search and seizure operation can normally be carried out only after obtaining permission from the Commissioner. These powers apply to all taxpayers, whether resident or non-resident, in respect of books of account and assets located in India.

Trend of court decisions

The latest trend of decisions of the Supreme Court in India is having a very important impact on tax avoidance. The boundary between tax planning, tax avoidance and tax evasion is becoming thinner and thinner. The Supreme Court has observed in the case of *Mc Dowell and Co. Ltd. v. Commercial Tax Officer* (1985), 154 *ITR* 148, that it is wrong to encourage tax avoidance by subterfuge. Earlier, the courts, including the Supreme Court, had held that a taxpayer could arrange his affairs in such a manner as to reduce his tax liability to the minimum. This view has undergone a radical change after the *Mc Dowell* decision and the Supreme Court has started frowning upon attempts at tax avoidance. The observations made by the Supreme Court in the case of *Mc Dowell* on 17 April 1985 have again been reaffirmed by it in a judgement delivered on 27 September 1985 in the case of *Sunil Siddarthabhoi and Kartikey v. Sarabhai,* 49 *Current Tax Reporter* (SC) 172. In view of these decisions by the highest court, lower courts and tax authorities are also expected to view attempts at tax avoidance more seriously and treat them as attempts at tax evasion. Consequently, tax avoidance by multinationals may also be subjected to stricter treatment and may be visited with higher penalties and deterrent punishment.

TAX REFORM

The above study has raised a few important issues. There is room for reform in the following areas:

(a) The most difficult problem which sometimes arises in the tax assessment of MNCs is the determination of a fair prevailing market price with respect to transfer pricing. This problem can be solved, to some extent, if reciprocal provisions are made in the tax treaties or tax laws of member countries of the United Nations for exchange of information for fixing the prevailing price.

(b) An alternative solution to the often vexing problem of fixing prevailing prices is to fix "floor prices". Goods should not be allowed to be exported below floor prices, which may be announced periodically, after a review of the prevailing international market prices.

(c) Section 92 of the IT Act covers only transactions between a resident and a closely-connected non-resident. In the U.K., the law also applies to non-resident associates.[2] The position under the Indian Income-tax Act is not clear. To remove doubts and to clarify the legal position, Section 92 should be amended to include non-resident associates, in addition to closely-connected non-residents.

(d) The calculation of admissible head office expenditure in the case of a foreign company under Section 44C is by no means simple. It should be reviewed and linked to a percentage of the turnover in India in the previous year. The percentage may be prescribed by the Central Board of Direct Taxes after examining some representative cases.

(e) A "sidestream loan" by a subsidiary to a parent company is as much a disguised dividend as an upstream loan. The definition of a dividend in Section 2(22)(e) needs elaboration to also cover sidestream loans.

(f) After the Supreme Court's decision in the *Mc Dowell* case, tax authorities may view with suspicion every effort of the taxpayer to reduce directly or indirectly his tax burden. This may create hardship in many genuine cases. It is necessary to have a clear distinction between tax evasion, on the one side, and tax avoidance permitted by law, on the other. This will have to wait, however, until a suitable case comes before the Supreme Court.

2. *Petrotim Securities Ltd., v. Aryes,* 41 *TC* 389.

ANNEX

Nature of receipt	Deduction for expenses incurred for earning such income	Effective date
(a) Royalties or technical service fees received from the Government or an Indian concern in pursuance of an agreement made before 1/4/76.	Expenses up to a ceiling of 20% of the gross amount of such income, as reduced by the amount, if any, of a lump-sum royalty for transfer outside India of technical know-how or information.	Applicable to royalties and technical fees received from the Government on or after 1/6/83 and from an Indian concern on or after 1/6/76.
(b) Royalties or technical fees received from the Government or an Indian concern in pursuance of an agreement made on or after 1/4/76.	No expenses allowed. Assessed on gross basis. Tax is charged at concessional rates as specified in new Section 115A. Lump-sum royalty: 20% of gross receipt. Non-lump-sum royalties and technical fees: 40% of gross receipt.	Applicable to royalties and technical fees received from the Government on or after 1/6/83 and to royalties and technical fees received from an Indian concern on or after 1/6/76. The gross basis is now uniform both for receipts from the Government and an Indian concern.
(c) Dividends	No expenses are allowed. Assessed on gross basis. Deduction under Section 80M in respect of inter-corporate dividends also withdrawn. Tax charged at concessional flat rate of 25% under Section 115A.	Applicable to dividends declared on or after 1/6/83.
(d) Interest	No expenses are allowed. Assessed on gross basis. Tax charged at concessional flat rate of 25% under Section 115A.	Applicable to interest received on or after 1/6/83.

In the Finance Bill 1986 it is proposed to partially amend the above rate schedule and charge income tax on the income by way of royalty (including income by way of lump-sum consideration) or fees for technical services, included in the total income of a foreign company, at a uniform rate of 30%. This amendment will take effect from 1 April 1987 and will accordingly apply in relation to the assessment year 1987-88 and subsequent years.

[continued from page 299]

tion on rental income beginning in 1985 may have caused a decline in the number of new housing units and buildings constructed in Burkina Faso over the past eighteen months, and that such an effect may continue. One should not assume that the effect upon incentives that follows from such taxation of rental property income is trivial, particularly if other tax measures also affect potential property owners simultaneously and unfavorably. However, with reference specifically to the capital city, Ouagadougou, such a slowdown in construction would not be altogether a bad thing if it were to contribute to a somewhat slower and more manageable growth rate of its urban population.[3]

On balance, the tax on rental property income seems likely to yield a significant amount of revenue, particularly if the tax continues to be administered well. The probable effects on the distribution of income are attractive to the Burkina Faso Government and to many of its citizens, and – as is often the case – the resulting economic effects may contain both negative and positive features.

3. Ouagadougou has not, in general, suffered the excessive and pell-mell growth and sprawl of Third World capital cities such as Lagos and Mexico City. Some ot the pressures for rapid urban growth in Ouagadougou have been tempered by the fact that Burkina Faso's industry tends to be concentrated in Bobo-Dioulasso, also located on the major road and rail line, but 400 kilometres closer to the Port of Abidjan, Ivory Coast. In addition, there has long been considerable seasonal labor migration out of Burkina Faso in search of employment in the plantations and cities of Ivory Coast.

SRI LANKA:

Withholding Tax on Interest – Operation of the Law

By R.G.L. de Silva

1. The Inland Revenue (Amendment) Act No. 56 of 1985 introduces a new chapter – Chapter XVA to the Inland Revenue Act No. 28 of 1979. The said Chapter XVA consists of Sections 113A to 113J and deals with "Deduction of Income Tax from interest paid by Banks and Financial Institutions". It came into operation with effect from 1 April 1986.

2. Section 113A provides that every bank and financial institution shall deduct from the interest payable by it on or after 1 April 1986 to any person chargeable with income tax, a withholding tax at 20% of the interest so payable. For the purpose of the withholding tax "financial institution" means any finance company or other institution (whether incorporated or unincorporated) whose business comprises the acceptance of deposits of money for payment of interest (Sec. 113J).

3. Persons who are liable to the withholding tax are those who are chargeable with income tax. Any person who is *not* chargeable with income tax is therefore entitled to make a declaration to that effect to the bank or financial institution which pays him interest and claim exemption from the withholding tax.

A "person" under the Inland Revenue Act includes an individual, a company, a corporation or a body of persons. In the case of a resident individual who is paid or credited with interest by a bank or financial institution, the liability to the withholding tax would arise only if his total annual income including interest exceeds the aggregate of the tax-free allowance of 27,000 Rs. and the allowance in respect of "qualifying payments" which he is entitled to under Section 30 and Section 31 respectively. The total amount of "qualifying payments" an individual (resident or non-resident) can claim as a deduction for the year of assessment 1986/87 and subsequent years is limited to 150,000 Rs. or 1/3 of his assessable income, whichever is less.

4. The following examples will illustrate the chargeability to the withholding tax in respect of a resident individual.

5. Any person who is chargeable with income tax at an average rate of tax below 20% could apply to the Commissioner of Inland Revenue (Withholding Tax) for a direction for a reduced rate of tax (the reduced rate may be 10% or 0%) – (see also example 2 in the column to the right).

Example 1

Income of Mr. X, a resident individual, for the year of assessment 1986/87 is as follows:

Interest on fixed deposits in the National Savings Bank		15,000 Rs.
Income from other sources		28,000 Rs.
Interest paid to the bank on overdraft		2,000 Rs.
"Qualifying payments"		
Contribution to approved provident fund	3,000 Rs.	
Insurance premia paid	4,000 Rs.	
Repayment of housing loan	2,000 Rs.	9,000 Rs.

Mr. X's liability for Y/A 1986/87

Interest from the N.S.B.	15,000 Rs.	
Less 1/3 (Exempt income, vide para. 6(1)(b) below)	5,000 Rs.	10,000 Rs.
Income from other sources		28,000 Rs.
Total income		38,000 Rs.
Less Interest on overdraft		2,000 Rs.
Assessable income		36,000 Rs.
Less Tax-free allowance	27,000 Rs.	
Qualifying payments	9,000 Rs.	36,000 Rs.
Taxable income		Nil

Since Mr. X is not chargeable with income tax for Y/A 1986/87 he should make a declaration to the National Savings Bank claiming exemption from the withholding tax.

Example 2

Income of Mr. Y, a resident individual, for the year of assessment 1986/87 is as follows:

Interest on fixed deposit in a finance co.		40,000 Rs.
Income from all other sources		35,000 Rs.
Qualifying payments		
Insurance premia paid	6,000 Rs.	
Approved investments, etc.	20,000 Rs.	
	26,000 Rs.	

Mr. Y's liability for Y/A 1986/87

Income from all sources		75,000 Rs.
Assessable income		75,000 Rs.
Less Tax-free allowance	27,000 Rs.	
Qualifying payments	25,000 Rs.	52,000 Rs.
Taxable income		23,000 Rs.
Income tax on 23,000 Rs.		
On the first 21,000 @ 10%	2,100 Rs.	
On the next 2,000 @ 20%	400 Rs.	
Total income tax payable	2,500 Rs.	

Since his average rate of tax is less than 20% Mr. Y could apply for a direction for a reduced rate of tax or claim a refund of the excess tax withheld (i.e. 20% of 40,000 Rs. – 2,500 Rs. = 5,500 Rs.) after the end of the year of assessment.

6. The following categories of interest will not be subject to the withholding tax under the law.

(1) Interest exempt from income tax under Section 10 as set out below:

(a) Interest receivable by an individual from Ceylon Savings Certificates or National Savings Bank Certificates purchased prior to 15 November 1978.

(b) 1/3 of the interest receivable by an individual from National Savings Certificates purchased after 15 November 1978 or from fixed deposits or savings accounts in the National Savings Bank or 2,000 Rs. whichever is higher.

(c) Interest receivable by any person from monies held in Special Accounts opened by exchange of foreign currency held abroad.

(d) Interest receivable by any person from monies held in foreign currency in a foreign currency banking unit (FCBU Accounts).

(e) Interest receivable by any person from monies held in foreign currency in a commercial bank (NRFC Accounts) during the period in which he is not resident in Sri Lanka and for the next 10 years from the date on which he commences to be resident in Sri Lanka.

(f) Interest receivable by any company, partnership or other body of persons outside Sri Lanka from any "approved" loans granted to the Sri Lanka Government or a Government agency.

(2) Interest payable to a person outside Sri Lanka, which is liable to tax at source at 33⅓%.

(3) Interest receivable from any person other than a bank or finance company.

7. Interest payable on the following deposits will also not be liable to withholding tax:

(a) Post Office Savings Bank Deposits.

(b) Savings accounts in which the balance does not exceed 10,000 Rs.

(c) Other deposit accounts where the aggregate balance of all such deposit accounts does not exceed 20,000 Rs.

(d) Special minors accounts, the interest from which is subject to income tax at 15% on maturity.

(e) Certificate of deposits.

(*Note*: The non-applicability of the withholding tax to interest on the above deposits is not due to any exemption granted by the law, but due to a concession granted administratively.)

8. Withholding tax is not a final income tax, but a tax deducted in advance. Such a tax can therefore be set off against any income tax due and payable. If the tax withheld on interest exceeds the income tax payable by the recipient/taxpayer he is entitled to a refund of the excess payment.

9. The Bank or the financial institution which deducts the withholding tax is required to furnish a statement to the Department of Inland Revenue showing the tax deducted and remitted and also to issue a certificate to each person from whom the tax has been withheld giving the particulars of tax withheld and the period to which it relates.

10. The deduction of withholding tax must be made at the time of payment (Section 113D). Any bank or financial institution which fails to deduct the withholding tax or remit to the Department of Inland Revenue the tax so deducted within the stipulated time, will be personally liable for the amount of tax not deducted or remitted (Section 113F). Notwithstanding the liability imposed on the bank or the financial institution under Section 113F the Revenue may also proceed to assess and recover the withholding tax not deducted by the bank or the financial institution from the person chargeable with such tax (i.e. assessee/recipient of interest). Thus the law empowers the Revenue either to assess the recipient of interest or proceed against the payer of interest for the recovery of the withholding tax which the payer of interest should have deducted and remitted to the Revenue.

11. If payments of tax are in arrears, penalties for default will accrue and both the taxpayer/recipient and the bank or financial institution may be liable for the penalties.

12. Any assessment in respect of withholding tax can be appealed against within 30 days from the date of notice of assessment. Provisions in Sections 117 to 122 in regard to appeals would apply to any appeal against withholding tax.

REPUBLIC OF SOUTH AFRICA:

The 1986 Income Tax Changes

By Dr. Erwin Spiro, LL.D (h.c.)

In the light of the advanced stage that the investigation of the Commission of Inquiry into the Tax Structure of the Republic of South Africa, under the chairmanship of Mr. Justice Margo, has reached, it did not seem to Mr. Barend Du Plessis, the Minister of Finance, when, on 17 March 1986, he delivered the Budget Speech, desirable to introduce far-reaching changes in the tax structure (it being preferable, as far as possible, not to disturb the status quo with respect to that structure). However, some adjustments, if not changes, were unavoidable. The Budget, endeavoring to give relief over a wide spectrum where the need is greatest, must change for those who will not be sharing in the tax concessions provision being made on the expenditure side.

I. PERSONAL INCOME TAX

Savings

The amount of interest income exempt from tax was raised last year from R 100 to R 250, and it is proposed to double the exemption limit to R 500 per year. The effect, at current interest rates, is that the interest on a taxable investment of about R 4,000 at a financial institution will be exempt from tax.

Working married couples

The R 1,600 of the wife's net earnings that is presently exempt from tax will be raised to 20% of her earnings with a minimum of R 1,800 being exempted from tax. The effect is that if the wife's salary is R 20,000 per annum the deduction will be R 4,000 as against the present R 1,600.

Surcharge of seven percent

The 7% surcharge, introduced last year, has been abolished with effect from the tax year beginning 1 March 1986.

Discount of five percent

To ease the tax burden on individuals further, it is proposed that a discount of 5% be granted to all income groups, with effect from 1 March 1986, on the net normal tax payable as determined after a deduction of tax rebates. The maximum marginal rate thus becomes 47.5%, but the income notch at which the maximum rate is reached remains R 60,000 for a married person and R 42,000 for an unmarried person.

Employees' tax: Individuals

Adjusted tax tables applicable to working married women will come into force on 1 July 1986. In the case of all other employees, the Commissioner for Inland Revenue is to immediately authorize employers to subtract 5% from the employees' tax payable, according to the employees' tax tables which came into force on 1 March 1986.

II. PROVISIONAL TAX: COMPANIES AND INDIVIDUALS

In October 1985 it was announced that persons older than 65 years would be exempted from rendering provisional returns, provided their taxable income did not exceed R 20,000 for the year of assessment in question and came only from investment income, salary and pension. It is further proposed that:

(a) the total of the first, second and third payments of provisional tax by companies be increased from 90% to 100% of their actual tax liability, with the proviso that, if the payments amount to more than the full liability, interest on the surplus will be paid by the State at the prescribed rate (this applies to years of assessment ending on or after 28 February 1986); and

(b) provisional taxpayers (other than companies) whose taxable income exceeds R 50,000 will also be liable for the third payment of provisional tax (as this will be in respect of years of assessment ending on or after 28 February 1987, the first additional payment will be due in August 1987).

It stands to reason that the proposed measures do not affect the total or final liability for taxation. They are merely a method to ensure that the full tax account is settled earlier.

III. RATES OF (NORMAL) INCOME TAX

Persons other than companies

Persons other than companies, in respect of their taxable income derived from sources within or deemed to be within the Republic for the year of assessment ending on 28 February 1987 or 30 June 1987, whichever is applicable, are subject to (normal) income tax calculated in accordance with Tables I and II below. There is to be deducted from the amount of tax calculated in accordance with the said Tables a discount equal to 5% of the net amount (being an amount arrived at by deducting the rebates provided for in section 6 of the Income Tax Act 1962 (Act No. 58 of 1962), from the tax so calculated).

Companies

Companies, in respect of taxable income derived from sources within or deemed to be within the Republic for every year of assessment of such company ending during the period of twelve months ending on 31

TABLE I

Taxable income	Rates of tax in respect of married persons
Where the taxable income –	
does not exceed R 12,000	16% of each R 1 of the taxable income;
exceeds R 12,000 but does not exceed R 13,000	R 1,920 plus 18% of the amount by which the taxable income exceeds R 12,000;
exceeds R 13,000 but does not exceed R 14,000	R 2,100 plus 20% of the amount by which the taxable income exceeds R 13,000;
exceeds R 14,000 but does not exceed R 15,000	R 2,300 plus 22% of the amount by which the taxable income exceeds R 14,000;
exceeds R 15,000 but does not exceed R 16,000	R 2,520 plus 24% of the amount by which the taxable income exceeds R 15,000;
exceeds R 16,000 but does not exceed R 18,000	R 2,760 plus 26% of the amount by which the taxable income exceeds R 16,000;
exceeds R 18,000 but does not exceed R 20,000	R 3,280 plus 28% of the amount by which the taxable income exceeds R 18,000;
exceeds R 20,000 but does not exceed R 22,000	R 3,840 plus 30% of the amount by which the taxable income exceeds R 20,000;
exceeds R 22,000 but does not exceed R 24,000	R 4,440 plus 32% of the amount by which the taxable income exceeds R 22,000;
exceeds R 24,000 but does not exceed R 26,000	R 5,080 plus 34% of the amount by which the taxable income exceeds R 24,000;
exceeds R 26,000 but does not exceed R 28,000	R 5,760 plus 36% of the amount by which the taxable income exceeds R 26,000;
exceeds R 28,000 but does not exceed R 30,000	R 6,480 plus 38% of the amount by which the taxable income exceeds R 28,000;
exceeds R 30,000 but does not exceed R 32,000	R 7,240 plus 40% of the amount by which the taxable income exceeds R 30,000;
exceeds R 32,000 but does not exceed R 34,000	R 8,040 plus 42% of the amount by which the taxable income exceeds R 32,000;
exceeds R 34,000 but does not exceed R 36,000	R 8,880 plus 43% of the amount by which the taxable income exceeds R 34,000;
exceeds R 36,000 but does not exceed R 38,000	R 9,740 plus 44% of the amount by which the taxable income exceeds R 36,000;
exceeds R 38,000 but does not exceed R 40,000	R 10,620 plus 45% of the amount by which the taxable income exceeds R 38,000;
exceeds R 40,000 but does not exceed R 50,000	R 11,520 plus 46% of the amount by which the taxable income exceeds R 40,000;
exceeds R 50,000 but does not exceed R 60,000	R 16,120 plus 48% of the amount by which the taxable income exceeds R 50,000;
exceeds R 60,000	R 20,920 plus 50% of the amount by which the taxable income exceeds R 60,000.

March 1987, are subject to the following rates of (normal) income tax:

(i) on each rand of taxable income (excluding taxable income derived from mining operations and taxable income referred to in (ii)(c) 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 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% 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.

TABLE II

Taxable 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 amount by which the taxable income exceeds R 10,000;
exceeds R 11,000 but does not exceed R 12,000	R 1,780 plus 20% of the amount by which the taxable income exceeds R 11,000;
exceeds R 12,000 but does not exceed R 13,000	R 1,980 plus 22% of the amount by which the taxable income exceeds R 12,000;
exceeds R 13,000 but does not exceed R 14,000	R 2,200 plus 24% of the amount by which the taxable income exceeds R 13,000;
exceeds R 14,000 but does not exceed R 15,000	R 2,440 plus 26% of the amount by which the taxable income exceeds R 14,000;
exceeds R 15,000 but does not exceed R 16,000	R 2,700 plus 28% of the amount by which the taxable income exceeds R 15,000;
exceeds R 16,000 but does not exceed R 18,000	R 2,980 plus 30% of the amount by which the taxable income exceeds R 16,000;
exceeds R 18,000 but does not exceed R 20,000	R 3,580 plus 32% of the amount by which the taxable income exceeds R 18,000;
exceeds R 20,000 but does not exceed R 22,000	R 4,220 plus 34% of the amount by which the taxable income exceeds R 20,000;
exceeds R 22,000 but does not exceed R 24,000	R 4,900 plus 36% of the amount by which the taxable income exceeds R 22,000;
exceeds R 24,000 but does not exceed R 26,000	R 5,620 plus 38% of the amount by which the taxable income exceeds R 24,000;
exceeds R 26,000 but does not exceed R 28,000	R 6,380 plus 40% of the amount by which the taxable income exceeds R 26,000;
exceeds R 28,000 but does not exceed R 30,000	R 7,180 plus 42% of the amount by which the taxable income exceeds R 28,000;
exceeds R 30,000 but does not exceed R 32,000	R 8,020 plus 44% of the amount by which the taxable income exceeds R 30,000;
exceeds R 32,000 but does not exceed R 34,000	R 8,900 plus 45% of the amount by which the taxable income exceeds R 32,000;
exceeds R 34,000 but does not exceed R 36,000	R 9,800 plus 46% of the amount by which the taxable income exceeds R 34,000;
exceeds R 36,000 but does not exceed R 38,000	R 10,720 plus 47% of the amount by which the taxable income exceeds R 36,000;
exceeds R 38,000 but does not exceed R 40,000	R 11,660 plus 48% of the amount by which the taxable income exceeds R 38,000;
exceeds R 40,000 but does not exceed R 42,000	R 12,620 plus 49% of the amount by which the taxable income exceeds R 40,000;
exceeds R 42000	R 13,600 plus 50% of the amount by which the taxable income exceeds R 42,000.

IV. RATES OF OTHER TAXES CONTAINED IN THE INCOME TAX ACT

Non-resident shareholders' tax

The non-resident shareholders' tax is 15% of the amount of the dividend (or interim dividend) in question.

Undistributed profits tax

The undistributed profits tax is 33⅓ cents on every rand by which the "distributable income", as defined, exceeds the amount of dividends distributed during the "specified period", as defined.

Non-residents' tax on interest

The non-residents' tax on interest is 10% on the amount of the interest in question.

Donations tax

The donations tax is a tax at progressive block rates, the block exceeding R 90,000 being taxable at the rate of 25%.

TAIWAN:

The Value Added Tax Law in Force

By Jap Kim Siong

INTRODUCTION

The new Business Tax Bill promulgated on 15 November 1985 proposing a value added tax* entered into force on 1 April 1986, together with its implementing rules promulgated on 16 January 1986.

The Business Tax Law 1985 replaces the Business Tax Law 1931, as amended. Under the Business Tax Law 1931, as amended, a business tax (*Yingyeshui*) was levied, also known as the gross business receipts tax which in character is a business turnover tax levied on gross revenue of a taxpayer's business turnover.

The Business Tax Law 1985 comprises two kinds of business taxes, the general business tax, hereinafter referred to as VAT business tax and special business tax, hereafter referred to as business turnover tax, similar in nature to the original business tax. However, the present business turnover tax is only imposed on the business activities mentioned in the Business Tax Law 1985, whereas the former was levied from all profit-seeking enterprises. The reform of the indirect taxes on goods and services aims to replace the so-called three-tiered taxes which involve the separate levy of the business tax, commodity tax and stamp duty on invoices covering the same taxable events. The reform abolishes the stamp duty on invoices only, but will in a later stage abolish all stamp duties and commodity taxes except a commodity tax on luxury goods. In the initial stage, however, a commodity tax is levied side-by-side with VAT business tax, but the commodity tax is included in the taxable base of the VAT business tax. However, the commodity tax on plastics, furs, etc., has been abolished and the rates on some oil products have been reduced.

The present outline will focus on the VAT business tax and business turnover tax governed by the Business Tax Law 1985 published in *Caizhengbu Gongbao* (Ministry of Finance Gazette) of 17 December 1985.

TRANSITION PERIOD

The former business turnover tax, stamp duty and commodity tax included in the cost of merchandise, materials, work-in-process and finished goods, which are included in inventory obtained prior to 1 April 1986, shall be offset against the VAT business tax payable after 31 March 1986. However, enterprises engaged solely in the business of selling or rendering tax-exempt goods or services and those businesses subject to business turnover tax are not entitled to this tax credit.

TAXABLE EVENTS

The taxable events may apply both to VAT business tax or business turnover tax as the case may occur. It is imposed on the sale of goods or services rendered within Taiwan and on the import of goods into Taiwan.

The term "sale of goods" is the transfer of title to goods to others for a consideration, except professional services rendered by free professions, and services rendered by employees to employers. Any of the following circumstances is regarded as a sale of goods:
- goods produced, imported or purchased by an enterprise for sale, but in fact used by itself or transferred to others for no consideration;
- goods used to redeem debt or distributed to shareholders or investors are deemed to be sale of goods when the enterprise is dissolved or closed;
- where the enterprise purchases goods under its own name on behalf of a third party and delivers the goods to the third party;
- where an enterprise requests a third party to sell goods on its behalf;
- where an enterprise sells the consigned goods.

The above-mentioned circumstances also apply to sale of services.

The following circumstances are considered to be sale of goods within Taiwan:
- the goods sold are required to be delivered abroad and the shipping point is within the territory of Taiwan;
- the goods sold are not required to be delivered abroad and the location of the goods is within the territory of Taiwan.

Any of the following circumstances are considered to be a sale of services within Taiwan:
- the services are rendered or used within Taiwan;
- an international transport enterprise carrying outbound passengers and cargoes from within Taiwan;
- a foreign insurance company accepts reinsurance from an insurance enterprise within Taiwan.

Any of the following circumstances is regarded to be an import of goods:
- the goods are imported into Taiwan with the exception of the goods imported by the enterprises located in Export Processing Zones, in Science-based Industrial Park, or by a bonded factory or bonded warehouse supervised by the customs administration;
- the goods are transferred from the Export Processing Zone, etc., to other areas within Taiwan.

A. BUSINESS TURNOVER TAX

Taxable persons

Business turnover tax is payable by the following taxable persons:
- enterprises engaged in banking, insurance, trust and investment, securities and brokerage, short-

* See "Taiwan: An Outline of the Proposed Value Added Tax System" in 40 *Bulletin* at 18 (1986).

term commercial papers and pawn shops;
- night clubs, entertainment facilities, saloons, tea rooms, coffee shops and bars;
- small-scale enterprises having gross monthly revenue of less than NT$ 200,000 and not operating luxury, tourist or barber-shops and bath houses.

Small-scale businesses and others

Option for VAT business tax

Small-scale businesses and banks, insurance, trust and investment companies engaging in activities not within their own scope of business like non-financing activities such as the leasing of warehouses, equipment or safe deposit boxes or investment in immovable property may, with respect to all or the part of the non-financing activities, request approval from the Ministry of Finance to be subject to the VAT business tax instead of the business turnover tax. Once the application has been approved, no changes can be made within 3 years.

Business turnover tax: special tax credit

Small-scale businesses and other businesses which are exempt by the Minister of Finance from filing sales returns shall be assessed on the business turnover tax amount determined by the collection authority.

When such a small-scale enterprise purchases goods or services for business purposes and obtains evidence of the business tax period on filing its return, a special deduction of 10% of the paid tax on purchases is deducted from the business turnover tax amount due on sales. However, when the business turnover tax due is less than the minimum amount assessable, the deduction is not applicable. In case the deduction exceeds the business turnover tax due, the excess can be carried forward and is deductible in the following period or periods.

The minimum amount assessable shall be prescribed by the Ministry of Finance.

The implementing rules stipulate that, where a taxpayer whose business turnover tax is determined by the collection tax authority claims a 10% tax credit on the tax paid on goods or services purchased, the taxpayer's supporting documents of the paid tax shall be filed with the collection tax authority on a quarterly basis on the 5th day of January, April, July and October.

Tax credit cannot be claimed if the documents are not filed within the aforementioned deadlines or if the documents submitted do not fall within the current period.

The term "other enterprises exempt by the Minister of Finance from filing sales returns" refers to the following operating business:
- barber-shops and hair saloons,
- bathhouses,
- taxi operators, and
- other businesses approved by the Ministry of Finance.

Taxable base and assessment

In general, the taxable base is the gross revenue. However, the collection authority may determine the taxable base and make a tax assessment every month on a taxpayer engaged in special restaurants, coffee shops, saloons, etc. The collection authority determines the taxable base and makes a tax assessment every 3 months with respect to pawnshops, small-scale enterprises and those enterprises engaged in banking, insurance, and trusts and investment, etc.

The Ministry of Finance prescribes the rules to determine the taxable base.

Business turnover tax rates

- Enterprises engaged in banking, insurance, trusts and investment, securities and brokerage and short-term commercial paper services and pawnshops: 5% (was 4% to 6%).
- Income from reinsurance activities by insurance companies: 1% (was 4% to 6%).
- Night clubs and restaurants without entertainment facilities: 15% (was 10% to 12%).
- Night clubs, saloons, tea rooms, coffee shops and bars with special hostesses: 25% (was 30% to 45%).
- Small-scale enterprises: 1% (was 0.6 to 1%).

B. VAT BUSINESS TAX

Taxpayers of VAT business tax are:
- sellers of goods or providers of services;
- the receivers or holders of imported goods;
- those who receive services provided by foreign enterprises, institutions, organizations or entities which have no fixed place of business in Taiwan. Also agents who handle business for international transport enterprises which have no fixed place of business in Taiwan.

Any of the following entities is regarded as a taxable enterprise or person:
- a profit-seeking enterprise owned by private persons, government or jointly owned by both;
- a non-profit-seeking enterprise, institution, entity or organization which sells goods or services;
- a foreign enterprise, entity, institution or organization which has a fixed place of business in Taiwan.

Exemptions

The following sale of goods and rendered services are exempt from VAT business tax:
- sale of land;
- water used in farmland;
- health services, medicine, lodging and meals provided by hospitals, clinics and sanatoriums;

- educational services offered by schools, kindergartens and other educational and cultural institutions;
- textbooks and officially supported academic writings issued by the publishing industry;
- services rendered by post and telecommunication offices;
- sale of goods by government monopoly industries;
- sale of postage stamps;
- sale of goods or rendered services by peddlers or hawkers;
- proceeds received by farmers from selling agricultural, forestry, fishing and pastoral products;
- proceeds received by fishermen from selling caught fish;
- sale of rice and wheat flour and rice husking;
- sale of fixed assets on which business tax has been levied;
- sale of weapons, warships, aircraft, tanks, etc. to the armed forces of Taiwan;
- fertilizers, pesticides and animal medicines used in breeding livestock, farming machinery and equipment sold to farmers; and
- approximately 14 other categories of sales and services.

Enterprises which sell exempt-goods or render exempt-services can apply to the Ministry of Finance for approval to be subject to the VAT business tax. Once the application has been approved, no changes can be made within 3 years.

VAT business tax rates

(1) General rate

The general VAT business tax rate is set at 5% determined by the Executive Yuan. However, the law provides that the VAT business tax rate shall be set not lower than 5% and not higher than 10%.

(2) Zero rate

The VAT business tax rate is zero for the sales of goods and rendered services in the following cases:
- export of goods;
- services related to export or services offered within Taiwan, but used in foreign countries;
- goods sold to outbound or transit passengers by tax-free shops;
- the sale of machinery and equipment, materials, fuel and unfinished goods to export enterprises located in Export Processing Zones, Science-based Industrial Park or to bonded factories or bonded warehouses supervised by the customs administration;
- international transportation, provided that reciprocal exemption from VAT business taxes is given to international transport companies of Taiwan by the foreign country;
- vessels and aircrafts used in international transportation and deep sea fishing boats;
- sales of goods and maintenance services to vessels and aircrafts used for international transport and deep sea fishing boats.

Only enterprises which obtain the foreign exchange to sell or deposit to a government appointed bank can qualify for the zero-rate in case of export of goods and services related to exports of goods or services offered in Taiwan for use in foreign countries.

Taxable base

Domestic sales

The taxable base is the total amount of all sales of goods and rendered services including all charges and the commodity tax, excluding the VAT business tax on said sales. The taxpayer is required to deduct the total amount of VAT (input tax) which it has already paid in connection with purchases in the particular month (as evidenced by invoices issued by sellers) from the VAT collected from its customers with respect to sales made in that month (output tax) and pay before the fifteenth day of the next month the difference to the Treasury as VAT business tax due for that month. If the tax paid on purchased goods and services (input tax) exceeds the tax paid on sales (output tax) the overpaid amount will be refunded if it is the result from the zero-rated goods or services. Otherwise, the overpayment will be carried forward and offset against future VAT business tax payable.

In any of the following events, input tax shall not be deducted from output tax:
- where supporting documents with respect to purchases are not obtained or kept properly;
- purchase of goods or services incurred other than for the normal operation of the enterprise or its branch;
- goods or services for use by employees;
- passenger sedan cars for own use.

Input tax is not refundable to enterprises solely engaged in the businesses exempt from VAT business tax. However, tax-free shops having their sales of goods to tourists zero-rated, must record the buyers' passport numbers on the sales receipts.

Whenever the selling price is unreasonably lower than the market price the local competent collection authority may determine the sales amount based on the market price. In case of a barter deal, the transaction price for the deal shall be either the fair market price of the buyer or the seller's goods, whichever is higher.

In case of goods purchased by a purchasing agent, the taxable base is the actual purchase price of the goods. Where goods are sold by a sales agent, the taxable base is the price agreed upon between the agent and the party who entrusts the agent to sell.

Importation of goods

VAT business tax on importation of goods is collected by the customs authority at the moment of importation. The VAT business tax is calculated by applying the VAT rate to the total amount on which customs duties are chargeable which includes the customs duty and harbour construction fee.

If the imported good is also subject to the commodity tax, the VAT business tax is calculated on the total amount mentioned above plus the commodity tax.

Goods imported by an enterprise for its own business operation, subject to VAT business tax, are exempt from VAT business tax at the moment of importation of the goods, but VAT is imposed at the moment of sale.

Refunds

Any of the following amount of refundable VAT business tax claimed by a taxpayer shall, if deemed appropriate, be investigated prior to being refunded:
- the overpaid VAT business tax resulted from the sales of goods or rendered services qualifying for the zero-rate;
- the overpaid VAT business tax resulted from the acquisition of fixed assets;
- the overpaid VAT business tax resulted from cancellation of registration, amalgamation, dissolution or closure.

Refundable VAT business taxes, other than the aforementioned ones, may be offset against future VAT business tax payable.

Any VAT business tax overpaid by a fixed place of business shall be offset against future VAT business tax payable by the head office in case the registration of such fixed place of business has been cancelled.

The term "fixed place of business" means a fixed place for selling goods or rendering services, including a head office, an administrative office, a branch, an office, a factory, a maintenance shop, a workshop, a warehouse, a mining site, a construction site, a showroom, a liaison office, a service station, a sales outlet, an auction house and other similar places.

Tax return and payment

An enterprise, whether or not it has sales, must file a monthly return on the 15th day of the following month, reporting sales and tax payable or refundable with the collection authority. The tax payable must have been paid before filing the return which must be accompanied by a receipt. If the enterprise uses uniform invoices, it should enclose a detailed list of uniform invoices used.

The head office and other branches of the same enterprise located in Taiwan must file separate monthly returns to the local tax authority. However, the head offices of an enterprise in the VAT system may apply for approval from the Ministry of Finance to file a consolidated monthly return for the sales of goods or the rendering of services from the head office and its branches.

An agent of a foreign transport enterprise not having a fixed place of business in Taiwan must file the monthly return and pay the VAT business tax with respect to the outbound passengers and cargo.

For foreign enterprises performing services but not having a fixed place of business within Taiwan, the customers should calculate and pay the business tax before the 15th of the following month.

A foreign enterprise engaged in entertainment and deriving income from performances within Taiwan, shall file a monthly return as a resident enterprise and pay business tax within 15 days after the last performance when performances have been held at the same place for less than 30 days. Such enterprises must file and pay business tax before departure if the time limit for filing a return is after the date of departure.

The tax authority shall issue an assessment of business tax, additional assessment or surcharges in case of late filing or non-filing. Payment must be made within 10 days starting from the day following the day the assessment was received by the taxpayer.

Registration

Any enterprise with a fixed place of business in Taiwan must file individually with the local tax authority an application for business registration before commencing business.

Those enterprises solely in the business of sales of tax-free goods or services and government entities of various levels may be exempt from business registration.

Any change in business operation in case of amalgamation, sale or liquidation must file an application for registration of the change within 15 days.

Uniform invoices

Enterprises selling goods or performing services are obliged to issue uniform invoices to their customers.

The uniform invoices show the sales amount and the VAT business tax amount separately. The uniform invoices are printed and sold by the tax administration or the enterprise may be authorized to print its own invoices, in accordance with the regulations of the Ministry of Finance.

The collection authority may approve an enterprise to use cash register receipts instead of issuing uniform invoices. Enterprises of a special nature or small-scale enterprises may be exempt from issuing uniform invoices and may instead issue ordinary receipts.

A Summary of Singapore's 1986 Budget

By Lee Fook Hong, FCIS FAIA

The Minister for Finance, Dr. Richard Hu, presented Singapore's 1986 Budget to Parliament on 7 March 1986. Singapore's economic recovery took priority in the Budget and the focus was again on the business sector. The Budget provided generous relief, especially for taxpayers in the middle and lower income groups and the ailing hotel and property sectors.

The Minister's Budget Statement was relatively shorter this year, as Parliament had already debated at length on the state of Singapore's economy and the recommendations of the Economic Committee. As usual, the Statement was presented in the following sections:

Section I: Review of the economy
Section II: Financial Year 1986 Budget
Section III: Revenue and tax changes

Contents

SECTION I

Review of the economy

In introducing his review of the economy, the Minister said:

"The causes of the present recession have been well documented in the Economic Committee's Report. Externally, we have had to contend with a slowdown in international trade as a result of growing protectionism as well as structural changes in global demand and supply conditions affecting key sectors of our economy. The low and falling commodity prices which adversely affected the growth of our ASEAN neighbours have also resulted in less trade and tourist arrivals for us.

Internally, profit margins have been steadily eroded as wage costs outstripped increases in productivity. This has been aggravated by a sharp decline in construction and related activities following the completion of major private sector projects and the scaling down of our public housing programme.

The basic thrust of Government's response to these problems has been elaborated by the First Deputy Prime Minister and I shall not repeat them. I would, however, like to emphasize that we do have considerable control over internal factors. Measures to reduce costs can be and have been taken. We have among other things suspended payroll tax, cut skills development levy, and reduced CPF[1] contributions. This will restore the international competitiveness of our firms and traders to a considerable extent. We can supplement these measures by striving hard to increase our productivity and the quality of our products and services. In essence, how we overcome the internal problems depends on ourselves and the sacrifices we are prepared to make.

The external factors we have little control over. We are a price taker in world markets. How we fare will depend on the world economy in general and the US economy in particular. The recent fall in world oil prices will hopefully quicken the upturn in activities expected for the US and other industrial economies.

Restoring economic growth must be the key priority for the coming financial year. But while we tackle our present problems, we must not lose sight of longer term issues, in particular our future place in the world economy."

1. Central Provident Fund.

(a) Industrial development

The Minister, in stressing the need for industrial development, said:

"Our industrial development in the years ahead will depend on the pace of automation, and, increasingly, on research and development. The present level of R & D expenditure is not high, accounting for only 0.6% of GNP in 1984 although it has actually more than doubled since 1982.

This increasing trend should be encouraged to continue. More specialized research-orientated institutions along the lines of the Institute of Systems Science and the Institute of Molecular & Cell Biology must be established. However, this is only feasible if we have the necessary manpower. In this respect, the National University of Singapore (NUS) and Nanyang Technological Institute (NTI) should not let up in their efforts to train and acquire a wider pool of scientific and industrial experts. The Government will continue to assist by providing tax incentives and R & D grants to encourage private firms to undertake applied R & D activities. I will elaborate on this further when I come to the section on tax changes.

The structural changes accompanying the rapid rate of technological innovation in the developed countries will impact significantly on our future industrial development. Foreign companies that are presently automating their plants and operations will have insufficient resources to undertake any new investments overseas. Moreover, given the increased productivity from automation, there will be less economic advantage in establishing new facilities abroad simply to take advantage of lower wage costs.

It is, therefore, all the more critical that our manufacturers continually upgrade their operations and diversify their products. They should be more outward looking and seek out opportunities overseas. Being a small economy, we can never provide a big enough domestic market for them to survive and thrive."

(b) Trade development

The Minister cautioned that until the industrialized countries restore the health of their economies and increase employment, protectionism would continue to be rife. On the measures to overcome this, he suggested:

"Our best defence is to increase our productivity. At the same time, we must be nimble and adapt to new developments and changes in world markets and in demand and supply. For example, third country trade in commodities such as crude oil, rice, sugar and other products is estimated to be worth about $45 billion annually.

Countertrade is another area which will grow in importance. A recent study has estimated that countertrade currently accounts for between 8% to 10% of world trade. Firms must grasp the complexities of these new trading activities quickly and translate them into realizable gains. It has been observed time and again that our entrepreneurs are not as quick to sense changes in demand and tastes and keep in step with these changes. It has been said that if a new product is on show in Japan today, it will be on sale in Hong Kong the very next day. Singapore stores will only have it the following week.

Our traders must be more aggressive in their marketing strategies. They must know who their competitors are and what their consumers want. The Trade Development Board (TDB) will spearhead the Government's drive to expand and seek new markets for our traders. More export promotion activities will be devised and tailored to meet the needs of local exporters. The TDB will also help disseminate information to traders so as to assist them in penetrating non-traditional markets such as Latin America, Africa and South Asia. Greater efforts will at the same time be made to expand our traditional markets closer to home.

The Government will also minimize trade restrictions, simplify trade documentation and weed out bureaucratic red tape. Ultimately, however, it is the drive and business acumen of our manufacturers and traders that will determine whether they succeed in the world."

(c) Financial services

On financial services, the Minister said that the demand for financial services, especially those centred around fee-based activities such as fund management and new financial instruments such as financial futures, would continue to expand in this region. He then explained the strategy for growth in the area of financial services:

"Fiscal incentives have been implemented to encourage the fund management industry, and these will be augmented by further incentives which I will shortly announce. The Singapore International Monetary Exchange has progressed satisfactorily and currently lists four financial futures contracts. Later this year, a stock index futures contract will be introduced. SIMEX is also expected to introduce options trading early next year.

On the domestic front, steps will be taken by the Government to develop a fixed rate securities market so as to pave the way for companies to raise fixed rate funds. In the equity market, the resolution of the problems currently facing the local stockbroking industry and the introduction of a new Securities Industry Act will mark a new chapter in the annals of our stock market. The corporatization of the industry has begun with the Big 4 local banks gaining membership on the Stock Exchange of Singapore. This increased institutional participation will strengthen the industry and help regain investors' confidence in our stock market. Later this year, the unlisted securities market is expected to begin operations. This will provide an avenue for companies with good potential for growth, but which are unable to obtain a listing on the main board because of their limited track record, to raise capital.

A necessary prerequisite for further growth in any financial market is a sound and stable financial system. Therefore, in pursuing a strategy for growth, we must not lose sight of the need for uncompromising prudential standards. We will continue to monitor and maintain such standards."

(d) The property market

The Minister reported that his Ministry was actively considering the recommendations of the Property Market Consultative Committee to nurse the ailing property market back to health.

(e) Manpower development

Stressing the need for manpower development, the Minister said that it was crucial to educate each individual to his or her maximum potential and the lack of quantity in the workforce must be compensated by improved quality. He further added:

"It is essential that employers realize that they carry the main responsibility for upgrading and re-training workers. The workers must also play their part by being willing to attend retraining and upgrading programmes. Only then can we hope to improve our productivity and be prepared for the next phase of our growth."

In conclusion, the Minister cautioned that the need for a longer term perspective should not be ignored despite the present setbacks and the urgency to implement measures to restore the health of the economy. He said:

"In the short term, the Government has and will continue to take measures to overcome this recession. We will continually monitor the economic situation – both domestic and abroad, and prepare ourselves for the worst. We must regain our competitive position by ensuring that costs are minimized, and red tape cut.

In the long term, we must all work together to maximize our potential. New investments must be found. Our entire economic environment must be made favourable to business and enterprise.

The Government will continue to provide efficient infrastructure, educate and train our population to its fullest potential, and assist private enterprises to identify and seize new opportunities. In this regard, the Economic Committee's Report is timely. It has identified a number of growth areas which we will do well to exploit. If we do so and deal with the present recession correctly, we will be well placed to take off once again."

SECTION II

Financial Year 1986 Budget

Turning to the Financial Year 1986 Budget, the Minister explained that its objectives were two-fold: to restrain the growth in recurrent expenditure and to stimulate the economy through increased development expenditure.

He then proceeded to elaborate on the expenditure estimates (not discussed here).

SECTION III

Revenue and tax changes

The Minister reported that the impact of the many tax concessions announced since the last Budget would be clearly felt on Financial Year 1986 Consolidated Revenue, which was projected at $ 8.66 billion. The overall financial position for Financial Year 1986 was expected to be in deficit by $ 3.22 billion. These deficits would be financed by drawdowns on reserves and by domestic borrowings.

The Minister gave a reassurance that the taxes which had been temporarily suspended would not be reimposed for as long as it took the economy to recover.

Explaining that the Government was committed to avoid getting into a permanent Budget deficit, the Minister said that there might come a time when Singapore had to look for new ways to raise revenue. He continued:

"The First Deputy Prime Minister has already announced that some form of consumption tax is being considered. It is intended that we begin to put into place this year the machinery needed for the collection of consumption taxes. An early start is necessary as we need time to evaluate alternatives and install the administrative machinery.

Already, the proposal has sparked off keen interest and quick response from Members of this House and the public. I am well aware that consumption taxes will be unpopular.

They are seen to be unwieldy, inflationary and bad for tourism. Whilst some aspects of these claims are undoubtedly true, my Ministry officials who are studying the issue will make every effort to ensure that the less desirable side-effects are mitigated.

Nonetheless, the need for consumption taxes must be seen in the larger context of Singapore's economic imperatives. If Singapore is to survive as an economic entity, its productive sectors must be competitive. As direct taxes are lowered to meet competition, a point may be reached when consumption taxes will have to be brought in to provide a compensatory source of revenue."

Moving on to tax changes, the Minister said that he would also be dealing with some of the other recommendations of the Economic Committee.

Extracts of the Minister's speech on these matters are reproduced below:

(a) Individual income tax

"In order to provide immediate relief to taxpayers, the Government has decided to give an across-the-board exceptional rebate of 25% on personal income tax for Year of Assessment 1986. Revenue loss is estimated at $ 250 million. For Year of Assessment 1987, I have decided to revise the personal income tax rates downwards.

The top marginal rate has been brought down to 33% in line with the cut in the company tax rate whilst the lowest marginal rate has been reduced to 3.5%. Under the new rates, taxpayers will enjoy a tax reduction of between 16.3% to 21.7%. As members will note, I have given a larger tax reduction to the middle-income group whose chargeable income falls within $ 15,000 to $ 100,000. This group currently bears nearly 50% of the total individual income tax burden. This should further motivate our skilled workers and young professionals to work even harder and earn more.

But I have not forgotten those in the lower income brackets. On top of the reduced rates, I intend to increase the rebate on the tax payable on the first $ 10,000 of chargeable income from 10% to 15%. This will further alleviate their tax burden. The revenue loss as a result of the reduction in tax rates is estimated at $ 193 million per annum.

I would like to reiterate that the Government will strive to lower income tax rates whenever possible. Being an open economy, dependent mainly on our human resources, we must never allow our tax burden to be so high as to become a disincentive to work and enterprise."

(b) Company income tax

"The reduction in company tax rate to 33%, with effect from Year of Assessment 1987, will increase after-tax yields. The Government feels that a 33% tax rate, when compared with the rate in other countries, is sufficiently competitive to attract and retain investors.

I would, however, like to assure Members that we will continue to monitor our position and company tax rates will be reduced to meet competition whenever this proves necessary."

(c) Property tax

"A rebate of 30% on the property tax rate of 23% is presently given in respect of the following properties:

- all industrial and commercial properties,
- industrial and commercial lands which are vacant or under development, but including residential lands owned by development companies, and
- let-out URA,[2] HDB[3] and JTC[4] properties.

As announced by the First Deputy Prime Minister, the rebate will now be deepened to 50% from 1 July 86, and extended for a further two years until end 1988. Property owners are expected to pass on the additional 20% rebate to tenants, as in the previous exercise.

I now propose to introduce three additional changes to the property tax system.

First, with effect from 1 July 86, all lands under private development will be fully exempt from property tax. The exemption will apply from the time construction begins to the time that TOL[5] is granted. Details of the scheme are being worked out between my Ministry and the Ministry of National Development and these will be announced shortly.

Second, I propose to allow a change in the method of assessment of property tax for hotels. Presently guest rooms, restaurants and function rooms in hotels are assessed based on industry-wide indices such as occupancy rate and tariff averages. This has led to some rigidity in the system. For example, if the occupancy rate of a particular hotel falls, this is not accompanied by a reduction in the property tax payable unless the occupancy rates of other hotels also fall. Consequently, a hotel with low occupancy ends up paying more than its due share of property tax, whilst one with high occupancy ends up paying less.

I have, therefore, agreed to allow property tax on guest rooms, restaurants and function rooms in gazetted hotels to be assessed based on actual annual gross receipts. The property tax will then more accurately reflect the actual tariff and occupancy rate of each hotel. With effect from 1 July 86, their annual value will be pegged at 15% of gross receipts from room sales.

Similarly, the annual value of food and beverage outlets in these hotels will be pegged at 5% of their gross sales.

The other parts of the hotel such as management offices, shopping arcades and carparks will continue to be assessed using the present method of assessment.

I am also pleased to say that the Inland Revenue Department is looking into the feasibility of extending this method of assessment to other properties where it is appropriate to do so.

Third, to ease the cashflow of all property owners, I propose to allow payment of property tax by monthly installments. This will take effect from 1 July 86. Installment payments will, however, only be allowed through GIRO, including Inter-bank GIRO. This is so as not to increase the cost of collection."

(d) Investment allowance

"The Economic Committee has recommended the introduction of a 30% across-the-board investment allowance for expenditure on capital equipment and machinery. The Committee feels that this will encourage continued investments in plant and equipment.

My Ministry does not disagree with the need to stimulate capital investment. However, we feel that the

2. Urban Redevelopment Authority.
3. Housing and Development Board.
4. Jurong Town Corporation.
5. Temporary Occupational Licence.

existing capital allowances are more than adequate. From Year of Assessment 85, capital expenditure incurred on all plant and machinery could be written off in three years. In addition, equipment such as computers, robots and automation equipment can be fully written off in one year.

We must allow the effects of these incentives to work their way through the system before we consider new concessions.

The investment allowance proposal also has substantial revenue implications which must be carefully studied. It will alter the base of deductions for the computation of taxable profits and can affect income tax revenue collections permanently. It is for these reasons that we have not supported the proposal.

The EDB,[6] however, administers an incentive scheme whereby investment allowance of up to 50% of capital expenditure can be enjoyed on investments in certain plant and equipment. As earlier announced, the EDB will be more liberal in granting allowances under their scheme, particularly to trading and service companies."

(e) Fund management

"The present tax incentive scheme for fund management confers exemption from Singapore taxes on investment gains from funds managed on behalf of non-resident investors by approved fund managers in Singapore. These fund managers need to have Asian Currency Unit (ACU) licences and must be approved by the MAS[7] for purposes of the scheme. In addition, the fees they earn are taxed at a concessionary rate of 10%. To enjoy the incentive however, the funds have to be invested in overseas markets.

The feedback from fund managers is that it is difficult for the fund management industry in Singapore to thrive if local stocks and shares are not included in the scheme. Specialized fund managers who do not possess ACU licences have also indicated that they would like to participate in the scheme.

In view of this, I have decided to extend the incentive scheme for fund management to include:
- investments in local stocks and shares, and
- fund managers who do not have ACU licences but are approved for the purpose by MAS.

This will take immediate effect.

The scheme essentially removes any Singapore tax liability that may arise as a result of the non-resident having his funds managed in Singapore.

As before, the incentive will be confined to non-resident investors. Presently, these investors are required to make a signed declaration of their non-resident status. This will no longer be necessary. Instead, the fund managers will have to affirm the non-resident status of their clients."

(f) Post-pioneer incentive

"Pioneer incentives have been an important and useful tool in attracting high-value added investments to Singapore. Companies presently enjoying pioneer status pay no corporate tax. However, upon expiry of their pioneer period, they are taxed at the full corporate tax rate. This can lead to difficulties of adjustment when the full tax rate is levied.

To ease the transition, the Expansion Incentive Scheme will be suitably modified to enable such companies to enjoy an effective company tax rate of as low as 10%. This will encourage pioneer companies to continue their operations in Singapore upon expiry of their pioneer status. Details of the scheme are presently being worked out."

(g) Tax deferred R & D reserve

"The Economic Committee has identified the promotion of applied R & D as a corner-stone of our policy for industrial upgrading. I have, therefore, agreed to its recommendation that approved companies be allowed to set aside up to 20% of their taxable income as an R & D reserve which will be tax-exempt if spent within three years.

Presently available incentive schemes for R & D, that is, the 50% investment allowance on capital expenditure and the double deduction on operating expenses, will continue to be granted to approved companies. These amounts will, however, be offset against the 20% reserve. Any part of the reserve remaining after three years will be taxed and interest charged on the amount of tax deferred.

This incentive will take effect from Year of Assessment 87."

(h) Venture capital incentive

"In the 1984 Budget Statement, the House was informed of an incentive scheme to encourage enterprising local companies to invest in non-traditional areas and new technologies. Investments in these new fields are risky but nevertheless necessary if we are to progress ahead.

Under the incentive scheme, a local company can write off up to 50% of the equity invested in approved venture capital projects if the project incurs cumulative losses over three years. I propose to improve upon the scheme.

The investing company may now deduct, up to the full amount of its investment, any loss arising from the sale of shares in an approved project company. At the same time, the approved project company may carry forward its losses for write-off against future profits. The scheme will also be extended to individuals.

These improvements to the scheme will apply to investments made after 1 April 86. Other details are being worked out by my Ministry in consultation with EDB and these will be announced soon."

6. Economic Development Board.
7. Monetary Authority of Singapore.

(i) Future incentives

"The Government agrees with the Economic Committee that companies should be encouraged to establish their operational headquarters in Singapore. It also supports the recommendation that foreign income, particularly from the export of services and third country trading, should be taxed at a reduced rate in Singapore.

I have asked my officials to study the most appropriate fiscal measures to promote such activities. Details are being worked out and will be announced expeditiously.

The Economic Committee has also made a number of other tax recommendations. These relate to incentive schemes of one form or another. We recognize that incentives are still useful and necessary at this stage of our economic development. At the same time, I should emphasize that it is our intention to eventually move towards a broad-based low-tax regime. My Ministry will consider the other tax recommendations in the light of these considerations."

CONCLUSION

The Minister explained that the expenditure plans and tax changes were structured to give priority to economic recovery. In concluding his Budget Speech, the Minister said:

"Despite what the Government is doing, much of the success of our policies will depend on the world economic situation, over which we have little control. We should therefore not be overly sanguine about the pace of our recovery. However, I see no cause for despondency either, as there is much we can do to help ourselves. We have excellent infrastructure already in place, adequate financial resources and negligible foreign debt; a very comfortable position from which to face adversity. What we now need is for all Singaporeans to join together in launching the next phase of our economic development.

I am certain that we will be able to overcome our temporary setbacks. We often forget that we started with very little. Since Independence, we have been fortunate and able to build up a significant inheritance for the next generation. The evidence is all around us. This was in no small measure due to a dedicated Government that could mobilize a committed people. I feel confident that a younger generation, led by a younger leadership, will be equally successful."

APPENDIX I

SUMMARY OF FISCAL INCENTIVES ANNOUNCED IN 1985 WHICH AFFECT THE CENTRAL GOVERNMENT BUDGET[1]

		Revenue loss per annum
Announced 26 July 85		
1. 30% property tax rebate with effect from 1 July 85, for 1½ years for the following categories of properties:		
a) Owner-occupied industrial & commercial	$66m	
b) Let-out industrial & commercial	$95m	
c) Vacant lands, including land under development	$48m	
d) URA, HDB & JTC properties[2] (let out only)	$51m	$260.0m
4. Reduction in interest rate on new loans under the small Industries Finance Scheme (permanent)		$ 1.3m
Announced 31 August 85		
5. Reduction in ad valorem duty on petrol from 60% to 50% with effect from 2 September 85		$122.0m
6. Abolition of duty on fuel oil with effect from 2 September 85		$ 0.5m
7. Abolition of excise duty on refined sugar with effect from 1 September 85		$ 12.0m
Announced 24 October 85		
8. Suspension of tax on PUB gas & electricity charges with effect from 1 October 85		$ 92.0m
Total reductions in Government revenue		$488.0m

1. Does not take into account the revenue loss as a result of tariff reductions by statutory boards.
2. Announced on 31 August 1985.

APPENDIX II

REDUCTION IN PERSONAL INCOME TAX RATES WITH EFFECT FROM YEAR OF ASSESSMENT 87

Chargeable income group ($)	*YA 85[1] existing rates (%)*	*YA 87[2] revised rates (%)*	*Average reduction in tax (%)*
1 – 5,000	4	3.5	17.9
5,001 – 7,500	7	6	17.7
7,501 – 10,000	9	8	17.6
10,001 – 15,000	10	8	18.1
15,001 – 20,000	12	9	20.0
20,001 – 25,000	15	12	20.8
25,001 – 35,000	18	14	21.1
35,001 – 50,000	22	17	21.7
50,001 – 75,000	26	21	21.2
75,001 – 100,000	29	24	20.0
100,001 – 150,000	31	26	18.7
150,001 – 200,000	34	28	18.0
200,001 – 300,000	37	31	17.6
300,001 – 400,000	37	31	17.1
400,001 – 500,000	39	33	16.8
500,001 – 600,000	39	33	16.4
600,001 – 750,000	39	33	16.3
more than 750,000	40	33	16.8

1. From YA 85 onwards, a 10% rebate on the tax payable of up to the first $ 10,000 of chargeable income was given.
2. From YA 87 onwards, a 15% rebate on the tax payable of up to the first $ 10,000 of chargeable income will be given.

1986 BUDGET STATEMENT SUMMARY OF TAX CHANGES

For ease of reference, tax changes as announced in the 1986 Budget Statement are summarized below:

(a) Individual income tax

(1) For Year of Assessment 1986, an across-the-board exceptional rebate of 25% is given.
(2) For Year of Assessment 1987, the personal income tax rates will be revised downwards (see Appendix II).

(b) Company income tax

With effect from Year of Assessment 1987, company tax rate will be reduced from 40% to 33%.

(c) Property tax

(1) Presently, a rebate of 30% on the property tax rate of 23% is given in respect of the following properties:
- all industrial and commercial properties;
- industrial and commercial lands which are vacant or under development, including residential lands owned by development companies; and
- let-out URA, HDB and JTC properties.

This rebate will be deepened to 50% with effect from 1 July 1986 and extended for a further two years.
(2) With effect from 1 July 1986, all lands under private development will be fully exempt from property tax, from the time construction begins to the time that TOL is granted.
(3) Property tax on guest rooms, restaurants and function rooms in gazetted hotels will be assessed based on actual annual gross receipts. With effect from 1 July 1986, their annual value will be pegged as follows:
- Guest rooms – 15% of gross receipts from room sales.
- Food and beverage outlets – 5% of their gross sales.
- Other parts of hotel, e.g. management offices, shopping arcades, etc. – no change (present method of assessment).

(4) With effect from 1 July 1986, payment of property tax by monthly installments will be allowed, provided installment payments are made through GIRO, including Inter-bank GIRO.

(d) Investment allowance

The EDB will be more liberal in administering the Investment Allowance Scheme, particularly towards trading and service companies.

(e) Fund management

With effect from 7 March 1986, incentive scheme for fund management has been extended to include:
- investments in local stocks and shares; and
- fund managers who do not have ACU licences, but are approved for the purpose by MAS.

As before, the incentive is confined to non-resident investors. Previously, these investors are required to make a signed declaration of their non-resident status. Now, the fund managers will have to affirm the non-resident status of their clients.

(f) Post-pioneer incentive

The Expansion Incentive Scheme will be modified to enable pioneer companies to enjoy an effective company tax rate of as low as 10% upon expiry of their pioneer period.

(g) Tax deferred R & D reserve

With effect from the Year of Assessment 1987, approved companies will be allowed to set aside up to 20% of their taxable income as an R & D reserve which will be tax-exempt if spent within three years. Any part of the reserve remaining after three years will be taxed and interest charged on the amount of tax deferred.

(h) Venture capital incentive

With effect from 1 April 1986, a company investing in non-traditional areas and new technologies may deduct, up to the full amount of its investment, any loss arising from the sale of shares in an approved project company. Furthermore, the approved project company may carry forward its losses for write-off against future profits.

The scheme will also be extended to individuals.

HONG KONG:

Return to Balanced Budget

By Y.C. Jao*

After three consecutive years of fiscal deficit, Hong Kong's Financial Secretary, Sir John Bremridge, presented the Budget for 1986-87 on 26 February 1986 that promised a modest surplus and also contained a number of tax concessions. This welcome turnaround in fiscal affairs occurred despite a less-than-satisfactory performance of the economy. The real growth rate of Gross Domestic Product (GDP) for 1985 dropped sharply to 0.8% (as against an earlier projection of 7.2%) from 9.3% a year before.

1. RECENT TRENDS IN PUBLIC FINANCE

In the post-war period 1946-82, deficits were recorded in only four fiscal years, 1946-67, 1959-60, 1965-66, and 1974-75. In all other years, fiscal surpluses of various magnitudes had been achieved. It was almost taken for granted, before 1982, that at least a modest fiscal surplus could be permanently maintained. This illusory belief was rudely shattered in the fiscal year 1982-83, when a projected surplus of HK$ 5,000 million turned out to be a deficit of HK$ 3,500 million. As I have explained in earlier articles in the *Bulletin*, adverse changes in the political and economic environment, as well as errors in fiscal policy judgement and decision-making, contributed to a sharp reversal in fiscal trends. In the summer of 1982, diplomatic negotiations between the United Kingdom and the People's Republic of China on the future of Hong Kong touched off a profound crisis of confidence that manifested itself in capital flight and portfolio shift which in turn led to the collapse of the property and stock markets, and precipitous depreciation of the Hong Kong dollar. The political uncertainty during 1982-84 was compounded by the world-wide economic recession of 1981-82, which hit Hong Kong hard because of its heavy dependence on external trade. But the Government also committed serious errors of judgement when it assumed that sales of public land could continue indefinitely on the basis of a supposedly permanent property boom. When the property market collapsed in the latter half of 1982, therefore, Government land sales also plummeted from a forecast HK$ 13,400 million to HK$ 6,100 million. Equally seriously, the Government not only over-estimated revenue from land sales, but also failed to exercise prudent restraint on the growth of public expenditure. Instead, it implemented premature concession in 1982. As a result, two more consecutive years of deficit, to the tune of HK$ 2,993 million and HK$ 559 million respectively, ensued in 1983-84 and 1984-85. To cover these deficits, unprecedented for Hong Kong, the Government resorted to a combination of higher taxation (both direct and indirect), drawing down fiscal reserves and borrowing.[1]

The Sino-British Agreement, initialled on 26 September 1985 and formally signed on 19 December 1985 by the Governments of the United Kingdom and the People's Republic of China, has produced a considerable calming effect on the state of public confidence, at least over the short to intermediate run.[2] Under the agreement, sovereignty over the whole Hong Kong area is to revert to China on 1 July 1997, and Hong Kong itself will become a Special Administrative Region (SAR) of China that enjoys a high degree of autonomy. The current social and economic systems in Hong Kong will remain unchanged for 50 years after 1997. The existing laws, based essentially on the British system (i.e. the common law, rules of equity, ordinances, subordinate legislation and customary law) will be maintained, save for any that contravene the Basic Law (a kind of mini-constitution for Hong Kong currently being drafted). Except for defence and foreign affairs, which will be under China's control, the Hong Kong SAR may on its own maintain and develop economic and cultural relations with other countries, regions and international organizations. Hong Kong will retain the status of a free port and a separate customs territory.

It will be allowed to maintain an independent fiscal system, without the obligation of paying any taxes to the Central Government in China. The agreement reaffirms Hong Kong's status as an international financial centre after 1997. Its existing markets for foreign exchange, gold, securities and futures will continue to operate. There will be free flow of capital. The Hong Kong dollar will continue to circulate and remain freely convertible. In addition to Chinese, English may also be used in Government and the courts. Other provisions regarding individual rights and liberties also seem to be more detailed and comprehensive than originally expected. In sum, the institutional framework that in the past four decades has been responsible for Hong Kong's economic miracle appears to have been duly acknowledged and enshrined in the agreement.

Initial reaction to the agreement was one of relief or even euphoria among the local population. It also received the blessing of Hong Kong's major trading partners – the United States, European Economic

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1. See Y.C. Jao, "Hong Kong's 1983-84 Budget: Tax Proposals", *Bulletin*, Vol. 37, No. 6, pp. 265-67; Y.C. Jao, "Hong Kong's Revenue Proposals and Their Implications", *Bulletin*, Vol. 38, No. 7, July 1984, pp. 298-301.
2. The agreement is officially entitled "Joint Declaration of the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the People's Republic of China on the Question of Hong Kong". Its full text is contained in a White Paper published by Her Majesty's Government in London on 26 September 1984. It will be referred to hereinafter as the Joint Declaration.

Community, Japan, Canada, South Korea, Australia and the Association of Southeast Asian Nations (ASEAN). Apart from the political settlement, the economy also benefited from the US-led economic recovery in 1983-84, the real growth rate of GDP rising from 2.9% in 1982 to 6.5% in 1983 and further to 9.3% in 1984. Reflecting the return of confidence, the Hang Seng Index of stock prices rose steadily, despite occasional setbacks, from 746 on 13 July 1984, when there was still great tension concerning the outcome of the Sino-British negotiations, to 1752 on 31 December 1985. Equally impressive was the recovery of the real estate market. Land and property prices in 1985 were reported to have risen by 30-50%, depending on location, size and other attributes, compared to their trough in 1982.

These developments could not fail to produce a buoyant effect on Government revenues. Despite the significant slow-down of the economy in 1985, the robust growth in 1983 and 1984, coupled with the higher tax rates instituted in 1984, had contributed to a higher than expected revenue growth. Furthermore, tighter control of expenditure had resulted in a steady decline in the size of the public sector from 19.1% of GDP in 1982 to 16% in 1985. Thus the projected deficit for 1985-86 of HK$ 559 million is likely to end up as a surplus of about HK$ 98 million. For the current fiscal year, 1986-87, a surplus of HK$ 348 million has been budgetted. A summary of the General Revenue Account, the main operating account through which the Government's finances are controlled, is given in Table 1.

Table 1 should be self-explanatory except for the item "transfer to funds". To smooth out fluctuations in revenues and expenditures and to provide a firm backing to capital projects of a long-term nature, the Hong Kong Government has set up five funds, to which transfers from the General Revenue Account are regularly made. The funds are: Capital Works Reserve Fund, Development Loan Fund Home Ownership Fund, Student Loan Fund, and Mass Transit Fund. As of 31 March 1986, these funds had balances totalling some HK$ 10,000 million, against commitments of over HK$ 26,500 million.

Table 1

General Revenue Account

(million HK dollars)

	Actual				*Revised Estimate*	*Estimated (after revenue proposal)*
	1981-82	1982-83	1983-84	1984-85	1985-86	1986-87
Recurrent account						
Expenditure	16,295	20,499	22,876	25,992	29,326	32,363
Revenue	24,014	24,882	27,251	30,582	35,443	38,199
Surplus	7,719	4,383	4,375	4,590	6,117	5,836
Capital account						
Expenditure*	1,597	1,345	1,337	1,404	1,434	1,581
Revenue	10,299	6,216	3,149	4,756	4,468	1,693
Surplus	8,702	4,871	1,812	3,352	3,034	112
Surplus before transfers to funds	16,421	9,254	6,187	7,942	9,151	5,948
Transfers to funds	9,886	12,754	9,180	9,506	9,053	5,600
Surplus/(Deficit)	6,535	(3,500)	(2,993)	(1,564)	98	348
Government bonds proceeds	——	——	——	1,005	——	——
Total surplus/(Shortfall)	6,535	(3,500)	(2,993)	(559)	98	348

* Excluding transfer to funds

The importance of income from land and buildings in Hong Kong's fiscal revenue is underlined in Tables 2 and 3. As may be seen from Table 2, recurrent income (consisting of rates, property tax, crown rent) and capital income (consisting mainly of land sales) accounted regularly for a substantial proportion of total Government revenue (TGR), ranging from 13.4% in 1949-50 to as much as 44.8% in 1980-81. During the property boom of 1977-81, revenue from land and buildings on average accounted for about 36% of total Government revenue. Table 2 shows that land sales are of two types, public auction and tender, and private treaty grants, with the former accounting for the major proportion. Under British rule, all land in Hong Kong is legally owned by the Crown, which sells or grants leasehold interests.[3] The normal method of disposal is public auction or tender, but leases for special purposes (such as sites for capital-intensive industries that can introduce higher technology) may be awarded at cost by private treaty.

Under the terms of the Sino-British Joint Declaration, land grants and leases from 27 May 1985 (the date of entry into force of the agreement) are now made for terms expiring not later than 30 June 2047. They are made at a premium and nominal rental until 30 June 1997, after which date an annual rent equivalent to 3% of the property's rateable value will apply.

Moreover, from 27 May 1985 until 30 June 1997, proceeds from land sales shall, after deduction of the average cost of land production, be shared equally between the present Hong Kong Government and the future Hong Kong SAR Government, with the latter's share being deposited in banks incorporated in Hong Kong and shall not be drawn on except for the financing of land development and public works in Hong Kong. A joint Sino-British Land Commission has also been established in Hong Kong to implement provisions in the agreement concerning land matters.[4]

Perhaps conscious of the mistakes it had made in the past by over-reliance on land sales, the Hong Kong Government in its latest Budget has introduced a medium-term forecast of public finances for the period up to 1989-90. The forecast is based on assumptions of an average real growth rate of 4.5% and an inflation rate of the same amount in the 4-year period 1986-87 to 1980-90. Other policy guidelines are that total ex-

3. Formerly, leases were sold for terms of 75, 99 or 999 years, but were subsequently standardized to a term of 75 years in the urban areas, renewable at a reassessed annual rent under the Crown Leases Ordinance.
4. See Annex III, "Land Leases", in the Joint Declaration.

Table 2

Recurrent and Capital Revenue from Land and Buildings

(In current HK$ million)

	Recurrent		Capital		
	$m	*As % of TGR*	*$m*	*As % of TGR*	*(b) + (d)*
	(a)	(b)	(c)	(d)	%
1947-48	15.7	9.6	9.1	5.5	15.1
1948-49	23.2	11.9	5.9	3.0	14.9
1949-50	30.6	11.6	4.8	1.8	13.4
1950-51	43.3	14.8	6.0	2.1	16.9
1951-52	48.2	15.6	4.6	1.5	17.1
1952-53	53.4	13.9	11.1	2.9	16.8
1953-54	59.6	15.0	11.7	2.9	17.9
1954-55	62.6	14.4	20.7	4.8	19.2
1955-56	76.2	16.8	24.8	5.5	22.3
1956-57	85.4	16.8	24.9	4.9	21.7
1957-58	97.3	16.7	40.3	6.9	23.6
1958-59	102.5	16.3	42.4	6.7	23.0
1959-60	114.8	17.3	34.9	5.3	22.6
1960-61	140.0	16.3	83.5	9.7	26.0
1961-62	176.3	17.1	120.7	11.7	28.8
1962-63	187.0	14.9	238.5	19.0	33.9
1963-64	212.9	15.3	230.5	16.5	31.8
1964-65	240.3	15.8	175.2	11.5	27.3
1965-66	317.1	19.4	107.4	6.6	26.0
1966-67	347.1	19.1	82.0	4.5	23.6
1967-68	382.8	20.2	65.4	3.4	23.6
1968-69	397.5	19.1	67.2	3.2	22.3
1969-70	420.6	17.0	152.5	6.1	23.1
1970-71	450.8	14.7	320.6	10.4	25.1
1971-72	498.0	14.1	328.2	9.3	23.4
1972-73	534.6	10.8	788.1	16.0	26.8
1973-74	782.7	14.7	453.7	8.5	23.2
1974-75	884.5	14.9	372.7	6.3	21.2
1975-76	1,051.7	15.5	478.5	7.0	22.5
1976-77	1,254.8	16.1	760.1	9.8	25.9
1977-78	1,459.5	13.7	2,111.8	19.9	33.6
1978-79	1,599.5	12.3	2,492.9	19.2	31.5
1979-80	1,816.0	10.5	3,429.2	19.8	30.3
1980-81	2,034.7	6.6	11,773.6	38.2	44.8
1981-82	2,647.4	7.6	10,995.8	31.5	39.1
1982-83	2,746.3	8.5	5,885.9	18.3	26.8
1983-84	3,194.6	10.1	2,871.4	9.1	19.2
1984-85	3,661.5	9.7	4,836.0	12.8	22.5

Notes: TGR: Total Government revenue (consisting of total revenue in the General Revenue Account and revenue of the Urban Council, with transactions between the two eliminated; the various funds, such as the Development Loan Fund, are not included).

Recurrent revenue consists of rates, the Property Tax, Crown rent and a few minor items such as rents for use of bathing beaches and temporary use of Crown land.

Capital revenue consists mainly of revenue from land sales, modifications of lease conditions and, to a small extent, stamp duty on conveyances of land or land and buildings.

Sources: Director of Accounting Services, *Annual Reports.*
Commissioner of Inland Revenue, *Annual Reports.*
Commissioner of Rating and Valuation, *Annual Reports.*
Urban Council, *Annual Reports.*

penditure growth should not in real terms exceed the growth in GDP, that consolidated cash flow should be in balance, preferably with a small surplus, that capital expenditure growth should be maintained at around its present level (allowing for inflation), that at least

Table 3

Capital Revenue from Sales of New Leases

(In current HK$ million)

	Public auction and tender		Private treaty grants	
	$m	% of TCRFLS	$m	% of TCRFLS
1963-64	116.3	59.7	9.1	4.7
1964-65	60.9	45.8	5.2	3.9
1965-66	26.8	36.5	11.7	15.9
1966-67	26.1	53.8	4.7	9.7
1967-68	10.3	24.3	24.0	56.6
1968-69	15.9	39.8	10.4	26.1
1969-70	67.1	55.4	15.0	12.4
1970-71	165.4	60.9	8.5	3.1
1971-72	169.8	63.1	4.6	1.7
1972-73	557.2	83.2	6.6	1.0
1973-74	225.5	70.8	17.1	5.4
1974-75	194.5	67.7	17.1	5.9
1975-76	216.4	62.6	41.7	12.1
1976-77	324.9	58.3	25.7	4.6
1977-78	660.9	36.1	897.0	49.0
1978-79	1,215.1	60.5	458.9	22.9
1979-80	2,299.8	80.8	116.9	4.1
1980-81	9,290.2	86.3	681.9	6.3
1981-82	7,953.4	82.2	1,002.0	10.4
1982-83	4,119.9	81.6	558.8	11.1
1983-84	1,709.9	75.4	339.7	15.0
1984-85	2,970.7	69.6	622.2	14.6

Note: Figures not available for period before 1963-64.
TCRFLS: Total capital revenue from land sales.
Sources: Director of Accounting Services, *Annual Reports.*

50% of capital expenditure should be financed by the surplus on the operating account, and that the size of the civil service should grow at no more than 2-2.5% per annum. On the basis of these assumptions and guidelines, an underlying surplus of about HK$ 600 million over the forecast period is being planned.

2. REVENUE PROPOSALS

Against the background of medium-term strategy, this year's revenue proposals contain a number of tax increases as well as tax concessions. The increases are in fees and duties designed to maintain their yield in real terms and to stabilize the relationship between direct taxation and indirect taxation at around 59:41 in their relative proportion. They are summarized in Table 4.

Tax concessions relate to personal allowances, estate duty and profit tax. The supplementary personal allowance is increased from HK$ 7,500 to HK$ 8,500 for a single person and from HK$ 8,500 to HK$ 9,500 for a married person and his/her spouse. Thus, together with the basic allowance of HK$ 20,500, the total personal allowance is now HK$ 29,000 for a single person and HK$ 60,000 for a married couple. Furthermore, the total allowance for a resident dependent parent is increased by HK$ 1,000 to HK$ 12,000. In respect of the estate duty, the principal matrimonial home of a person who dies leaving a spouse, is now exempt, regardless of whether there is a will or not. The stamp duty of 1% on Hong Kong dollar debt

Table 4

Increases in Duties and Fees, 1986

Category	Percentage increase
Hydrocarbon oils	4.5%
Tobacco	11.8% on imported raw tobacco and locally manufactured tobacco
Vehicle and driving licence fees	4%
Banks and deposit-taking company licence fees	20% for bank licence and 13% for deposit-taking company licence

instruments is abolished. Finally, and perhaps most important, the proposal in the 1984-85 Budget that some interest earned on offshore deposits be brought under the ambit of profit tax is repealed. As I explained in an earlier article, the 1984 proposal was highly controversial, being widely interpreted by the business community as an infringement on the "territorial source" principle, on which the Hong Kong tax system rests. Moreover, it was made at a time when Hong Kong's arch-rival, Singapore, was reducing taxes to enhance its attractions as a financial centre vis-a-vis Hong Kong.[5] Not surprisingly, the repeal of the 1984 proposal and the abolition of stamp duty on Hong Kong dollar debt instruments have been warmly welcomed by the financial community as timely measures to maintain Hong Kong's status as a financial centre.

3. ASSESSMENT

Hong Kong went through a severe financial crisis in 1982-85, of which the fiscal crisis was an integral part.[6] The return to fiscal balance in 1986 is a welcome development that augurs well for the economy. At the same time, the fiscal balance is still too fragile to be taken as a permanent recovery. Thus, the fiscal reserve was estimated by the Financial Secretary to be about HK$ 15.6 billion in his Budget speech delivered on 26 February 1986. Of this, a sum of HK$ 7.5 billion was estimated by him to be necessary as a cover for various contingent liabilities, mainly guarantees on behalf of Government corporations such as the Mass Transit Railway Corporation and the Hong Kong Export Credit Insurance Corporation, etc. This leaves a "free" reserve of HK$ 8.1 billion, which is less than half a month's value of imports. By contrast, in 1981 the "free" fiscal reserve was estimated at HK$ 10.3 billion, or about one month's value of imports.[7] Moreover, since the Budget speech, the Government has used the Exchange Fund to bail out two banks in trouble, a move that has aroused considerable criticisms. The Exchange Fund, set up in 1935 to serve as the reserve backing for the currency, has been expanded since 1976 to include the fiscal reserve as well, so that it has now become the repository of the Government's assets, whether denominated in domestic or foreign currencies. The Financial Secretary has, however, strongly defended his use of the Exchange Fund for stabilization purposes. In his latest speech to the Legislative Council on 23 April 1986, he indicated that the 1985-86 surplus could reach HK$ 1,177 million, much higher than the HK$ 98 million originally estimated.

In recognition of its past error in relying too much on land sales, the Government has mapped out a medium-term strategy of achieving a small overall surplus over the next four years. While the underlying assumptions about real growth rate and inflation rate seem reasonable at present, for a territory like Hong Kong in transition between two different regimes, non-economic factors are likely to exert increasingly important influence. One worrying feature is the stagnant state of capital formation: from 1982 to 1985, fixed gross capital formation in real terms declined by 10%, a phenomenon indicative of a lack of long-term confidence. Thus, although the Sino-British agreement has calmed the jitters characteristic of the 1982-84 period, it has not removed completely the uncertainty over the long-term future. Much will depend on how faithfully the agreement is observed and implemented. This, in turn, depends in large measure on whether China's internal political stability and its present pragmatic and open-door policies can be maintained permanently.

5. See Y.C. Jao, "Hong Kong's Revenue Proposal and Their Implications", loc. cit.
6. The other components of the financial crisis were currency crisis and banking crisis. For a detailed analysis, see Y.C. Jao, "The 1997 Issue and Hong Kong's Financial Crisis", *Journal of Chinese Studies*, Vol. 2, No. 1, April 1985, pp. 113-154.
7. *The 1981-82 Budget*, paras. 109-112.

OECD Report: Trends in International Taxation

Taxation Issues relating to International Hiring-out of Labor

By Rijkele Betten

INTRODUCTION

On 21 September 1977 the OECD Council adopted a Recommendation on Tax Avoidance and Evasion and instructed the Committee on Fiscal Affairs to make specific proposals for increased cooperation between Member countries in this field.

The OECD Report on *Taxation issues relating to international hiring-out of labor* (hereinafter Report) deals with a specific type of tax avoidance and evasion.

This article presents an overview of the Report. First, some economic and legal aspects of hiring-out of labor are described. Second, negative consequences of abuse on a national and international level are discussed. Then the international tax question and the leading principle, which should be followed to resolve the issue, are described.

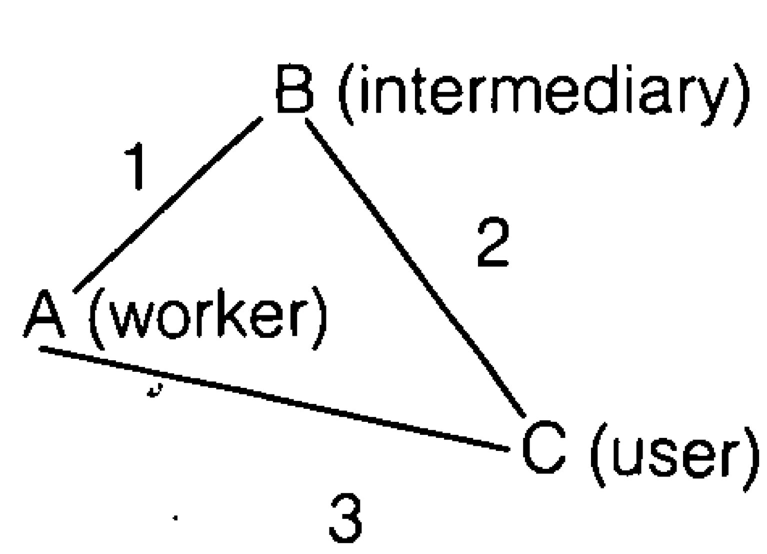
The analysis of solutions for abuse on the domestic level shows different opportunities for tackling abuse. Some of the domestic measures have international effects. The core of the Report is the discussion of possible international solutions to the international tax question. Lastly, some comments are made.

Hiring-out of labor

The hiring-out of labor arises where labor is provided to a user enterprise by an intermediary, usually for a limited time period. It includes at least three parties: the worker who provides the personal services, A; the intermediary who recruits and supplies the labor to the user, B; and the user for whom the services are exercised, C.

Figure 1

Relationships between the worker, A, the intermediary, B and the user, C:



Economic aspects

The hiring-out of labor developed because of a demand by user enterprises for flexible labor. Flexible labor is available as a result of the unemployment which is prevalent in almost all countries and because labor finds the opportunity to acquire in a short period of time a broad range of experiences attractive. To bring demand for and supply of flexible labor together, intermediaries are organized.

On a macro-economic level, the hiring-out of labor promotes the efficiency of the labor market. However, the increased efficiency is obtained at the cost of reduced social protection for workers. Hired-out workers have less rights to social security and fewer rights than permanent employees of the user enterprise.

Legal aspects

The legal relationships between the parties (Fig. 1) may be elaborated as follows:

1. The legal relationship between the worker (A) and the intermediary (B) can take the form of a contract of employment. For the purpose of taxation, B would, as a rule, be regarded as the employer. Many countries impose certain obligations on employers such as the withholding of wage taxes and the payment of social security contributions.

In attempting to escape these obligations, the intermediary may intentionally fail to conclude an employment contract. This may also occur in order to circumvent a legal prohibition on the hiring-out of labor (such as, in principle, Norway and for certain economic branches such as the building industry in Belgium).

2. The legal relationship between the intermediary (B) and the user (C) is usually such that the intermediary is only responsible for the provision of labor.

3. The legal relationship between the worker (A) and the user (C) should, according to the Report (point 4), be regarded as a "contract for service" if the worker is only expected to work at the user's place of business and to follow the user's instructions.

Abuse

The legal relationships mentioned above may be modified, for example, by interposing a "sub-contractor" relationship (between intermediary and user or between worker and user) or even by having no contracts at all.

Abuse may lead to undesirable results for the involved governments. First of all, public revenue may be reduced because of the non-payment of wage tax, value added tax or social security contributions. The financial "benefit" may be shared by the worker, the intermediary and the user. The worker, however, will be entitled to less social security protection if social security premiums are not paid. He may try to compensate for this by registering as unemployed.

A second undesirable result of abuse may be a distortion of the competitive conditions in the labor market and the user enterprise's market, especially when the participants in these markets do not bear all legally unavoidable costs.

Finally, abuse may serve as a bad example for other members of the community and lead to a reduction of the compliance morality in a country.

The (international) tax question

The interposition of an intermediary between the employee and the employer has led to great difficulties for tax authorities attempting to implement (or adapt) their taxation system in such a way as to levy the appropriate taxes on the incomes concerned.

There may be: an intermediary residing in country I; a worker residing in country L, but exercising labor in country U; and a user enterprise in country U. None of the parties, when they are interested in avoiding or evading taxes (i.e. the intermediary, the worker or the user) are particularly interested in informing the relevant tax administrations of these activities. Actual taxation thus becomes very difficult.

The parties involved may even succeed in avoiding taxes when all appropriate tax administrations are informed (the tax authorities being unable to cross-check the information supplied). For instance, the intermediary may inform the tax administration in country I that he is taxable in country U (or L) because he has a permanent establishment there, while claiming that there is no permanent establishment before the tax authorities in country U (or L) and, therefore, he is not taxable in that country.

The assessment and recovery of taxes can also be impeded when the intermediary is related to the workers and/or users, or when the intermediary resides in a tax haven. The contracts between the involved parties can be arranged in such a way that the contracts comply with tax relief laws in one or several countries. The contracts may also lead to the transfer of profits or funds to tax havens.

The assessment and recovery of taxes by a country are limited by both domestic and international law. Domestic law in the country of residence of the laborer may provide for a partial or total tax exemption for income from activities exercised in another country or at least not apply the Pay-As-You-Earn system (withholding wage tax) to such income. International law (not only tax treaties) may also reduce one country's right to tax certain types of income. Uncertainties about the application of tax treaties to hiring-out must be solved before actual taxation can be ensured.

The principle

In order to determine which country should have the right to tax income from hired-out labor the following principles are considered.

Under point 13 of the Report it is stated that: "as a matter of principle, any income arising from hiring-out activities should be taxed and such taxes should be paid in one country or another". Moreover, point 20 provides that "the existence of an intermediary should not result in no tax being paid".

In an international context, Art. 15 of the OECD Model provides for the attribution of the right to tax income from dependent services. The general rule is that such income is taxable in the State where the employment is actually exercised (Commentary to the 1977 OECD Model at page 131).

Domestic solutions

The most effective way of dealing with the problem of taxing hiring-out activities would be to forbid hiring-out activities.

For several reasons this option is not appropriate for each country. As reasons therefore one can mention that hiring-out activities raise economic productivity by providing temporary but experienced labor for the fulfillment of contracts during peaks in labor demand. A typical example of a sector in which these peaks occur is the building industry.

Furthermore, there is a widespread tendency (at least within the EEC and the Nordic countries) to stimulate free movement of labor which would be impeded by a prohibition of hiring-out of labor.

The second best solution is to make hiring-out of labor subject to various legal requirements which promote the availability of information to the government, as well as reduce the opportunity for tax abuse through the manipulation of legal relationships.

Intermediaries can, for example, only be allowed when they have a license, as in the Netherlands, or they can be registered (e.g. Belgium, France, Germany, the Netherlands and the United Kingdom). The use of unregistered intermediaries (by users) can be discouraged by creating a greater liability with respect to taxes and/or social security contributions for the users thereof,[1] as compared to users of registered intermediaries. Some countries such as Belgium and the

1. In Belgium these users have to withhold 30% from each payment and then pay it to the tax administration and the social security funds.

Netherlands publish regularly a list of registered intermediaries, while others, like the United Kingdom, only allow for public scrutiny.

Intermediaries are often held liable for the payment of VAT taxes, wage taxes and social security contributions, related to the hired-out labor.[2] The Netherlands provides for a Chain Responsibility, i.e. a liability for the obligations of (successive) subcontractors.

To obtain knowledge about the existence of intermediaries, information must be made available. Germany has a centralized file for this purpose. Cross-checkings and investigation methods can be made more effective through cooperation between tax authorities, social security agencies, labor authorities and informal cooperation with trade unions.

Information can also be obtained by requiring taxpayers to provide the tax authorities, upon request and/or unsolicited with information on, for example, third parties and their workers, as in Norway and the United Kingdom.

The user can be held liable for taxes and social security contributions when usage is made from unlicensed (e.g. the Netherlands) or unregistered intermediaries. Sweden followed an approach according to which the "real employer" has to be determined. The user can then possibly be seen as the "real employer". In principal, worker and employer are jointly liable.

In many countries employees are subject to a Pay-As-You-Earn system. To avoid this, employees can self-incorporate or become self-employed by acting as a subcontractor. In the United Kingdom's building industry tax deductions have to be made from payments to subcontractors (whether individuals or companies) which provide labor only, unless the subcontractor is registered and has a satisfactory tax record.

International aspects

Although the Report provided numerous possible domestic solutions for the taxation of the hiring-out of labor, it especially described solutions with international aspects.

International effects of the hiring-out of labor arise when not all the three involved parties reside in one country. Effective gathering of information may then, next to cooperation between tax and social security agencies, require cooperation with customs, exchange control, and immigration.

Non-resident intermediaries who want to hire out labor should have to be licensed in several countries.[3] They also could be made liable for the payment of VAT taxes, wage taxes and social security contributions, related to the hired-out labor. This is presently required in Germany, the Netherlands and the United Kingdom. In Norway, taxpayers (including non-residents) must provide information to the tax authorities concerning non-residents who have contracted for work on the continental shelf or, in some cases, for work on a construction site in Norway. Failure to provide information can lead to liability for taxes due by the non-resident(s).

In Belgium, a user of foreign labor (from an EEC Member country), which cannot show it is covered by a foreign social security system, has to report the employees' names to the social security agency. Non-residents hiring out labor in the construction industry must be registered and prove their status as an employer in the State of residence.

Hiring-out activities of a non-resident intermediary can result in liability for the withholding of wage tax, etc., but that liability can also be passed to their local branch, to the user of the hired-out labor, as in the United Kingdom, to the permanent representative of the non-resident or to the person in charge of the work being carried out, e.g. in the Netherlands.

International solutions

The discussion of possible instruments for an appropriate taxation on the hiring-out of labor on an international level and in an international context forms the essential part of the Report. The various instruments can be grouped into:

I. the exchange of information;
II. the interpretation of bilateral conventions; and
III. the recovery of taxes levied abroad.

I. Exchange of information

To be able to tackle the problems effectively, all countries must have a full picture of all relevant circumstances as, for example, the various contracts involved. Timeliness is also very important, however, there may be limitations under domestic laws which impede such a timely exchange of information.

In its Conclusions and Recommendations the Report states:

> There is general agreement that the principal key to present problems is information which, in this area, should be obtained as early as possible. It is one of the main aims of the present report to stimulate Member countries to increase their efforts in this respect both at domestic and at international level.

Emphasis is also put on the possibility of spontaneous exchange of information on the international level and on the use of telephone or telex. Cooperation between more than 2 countries is necessary if the parties involved are spread over more than 2 countries.

II. Interpretation of bilateral conventions

Once the relevant facts are known by the tax authorities, international hiring-out of labor requires the interpretation of tax treaties. Uncertainties about the

2. In Belgium, France, Germany, the Netherlands and the United Kingdom.
3. In France (only for recruiting), Italy and the Netherlands.

interpretation arise because of the mobile and temporary character of hired-out labor.

The Committee studied three different areas:
(1) the scope of Art. 15(2) of the OECD Model (especially of the term employer);
(2) the possibility to qualify the activities of an intermediary as a permanent establishment; and
(3) the international assessment and recovery possibilities.

(1) For the application of Art. 15[4] of the OECD Model, terms like employment and employer need to be applied to hiring-out of labor.

Art. 15(1) of the OECD Model provides that income from employment (dependent personal services) is taxable in the State where the work is actually exercised, whereas Art. 15(2) gives an exception for a specific situation. The Report states at point 57 that:

> It must be assumed that paragraph 2 was only aimed at cases where the employment is actually being exercised in a country on behalf of an employer which is not a resident of that country.

If, in a hiring-out situation, the intermediary resides in a country other than the place of the user enterprise and the employment activities, and the user is considered to be the employer, the exception of Art. 15(2) of the OECD Model is inapplicable (for the purpose of the application of the tax treaty).

Although this type of solution may be contrary to some countries' interpretation of double taxation conventions (point 58), the Committee appreciated such a "substance over form" approach.

To apply this specific interpretation to bilateral treaties, criteria are necessary for the determination of whether the intermediary or the user is the "real" employer. The Nordic "withholding tax agreement" contains some examples:

> In determining whether an employee shall be considered hired-out, a general evaluation shall be made where particular weight shall be put on whether:
> a) The authority to instruct the worker is with the user;
> b) The work is performed at a place which is under the control and responsibility of the user;
> c) The remuneration to the hirer is calculated on the basis of the time utilized, or there is in other ways a connection between the (calculation of) this remuneration and wages received by the employee;
> d) Tools and materials are essentially put at the employee's disposal by the user;
> e) The number and qualifications of the employees is not solely determined by the hirer.

There are, however, two important objections against this solution. First, the allocation of the right to tax, as such, is not enough for actual taxation as domestic legislation in the source-State must also make taxation possible. Second, in certain countries it is very difficult – if not legally impossible – to apply the concept of "substance over form" to existing tax treaties.

Therefore, the Committee invited the respective competent authorities to define by mutual agreement the ways in which paragraph 2 of Art. 15 should be applied to hiring-out of labor. So, in the future it may be expected that OECD Member countries insert provisions in their new treaties, according to which the user of the hired-out labor may be considered as the employer for the application of provisions similar to Art. 15(2) of the OECD Model to hiring-out of labor. Relevant circumstances are the exercise of full control and responsibility for the achievement of the work.

The Committee also considered the exclusion of hiring-out activities from the scope of Art. 15(2) and amendment of the 183-day rule.

Excluding hiring-out activities from the scope of Art. 15(2) was, however, thought to be inappropriate because that would constitute special treatment for a particular category of taxpayers and it might set an undesirable precedent for both OECD and non-OECD Member countries. Furthermore, international agreement on the definition of a "hiring-out situation" would be necessary and, finally, domestic legislation should make effective taxation possible.

Regarding the 183-day rule, the Committee, as stated at point 80, decided it would be advantageous to change the phrase "183 days in the fiscal year concerned" in Art. 15(2) to "183 days in twelve consecutive months".

2. Intermediaries try to avoid fulfilling the conditions for a permanent establishment because, in that case, the exception in Art. 15(2) of the OECD Model does not apply since the remuneration is then borne by a permanent establishment or fixed base of the employer in the country in which the labor is exercised.

Within the Committee, it was suggested to base tax liability in this case merely on the presence of activities in the country. However, several problems were mentioned: the allocation of profits between the head office and the permanent establishment and also, like in the case of excluding hiring-out activities from the scope of Art. 15(2), the setting of undesirable prece-

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4. Article 15
Dependent personal services

1. Subject to the provisions of Articles 16, 18 and 19, salaries, wages and other similar remuneration derived by a resident of a Contracting State in respect of an employment shall be taxable only in that State unless the employment is exercised in the other Contracting State. If the employment is so exercised, such remuneration as is derived therefrom may be taxed in that other State.

2. Notwithstanding the provisions of paragraph 1, remuneration derived by a resident of a Contracting State in respect of an employment exercised in the other Contracting State shall be taxable only in the first-mentioned State if:
a) the recipient is present in the other State for a period or periods not exceeding in the aggregate 183 days in the fiscal year concerned; and
b) the remuneration is paid by, or on behalf of, an employer who is not a resident of the other State; and
c) the remuneration is not borne by a permanent establishment or a fixed base which the employer has in the other State.

3. Notwithstanding the preceding provisions of this Article, remuneration derived in respect of an employment exercised aboard a ship or aircraft operated in international traffic or aboard a boat engaged in inland waterways transport, may be taxed in the Contracting State in which the place of effective management of the enterprise is situated.

dent for OECD and non-OECD Member countries. Therefore, the suggestion was not accepted.

3. Assessment and recovery: assistance in the recovery of taxes in an international context has not generally been provided. Domestic powers to enforce the payment of foreign taxes are a basic condition therefor. Thereafter, conventions for assistance in the recovery of tax claims can become valid.

Another issue is the liability to withhold wage tax. The liability can be placed with the user or the intermediary. Some countries' solutions have been set forth above. With respect to foreign intermediaries, the liability can be transferred to domestic representatives, as is the case in the United Kingdom and the Netherlands.

Another way of preventing the failure to levy tax is to put heavier obligations on users of unregistered intermediaries as compared to users of registered intermediaries (like in Belgium).

The liability for the withholding of wage tax can be put on the user or the intermediary; a determining factor in the United Kingdom for the attribution of this duty is whether the intermediary is responsible for the work performance. If the user can fire a workman without the interference of the intermediary then the user should withhold wage tax.

At the end, the Report states that:

> the work underway on a draft multilateral convention for mutual administrative assistance in tax matters is clearly encouraging (point 103).

COMMENT

Although the Committee on Fiscal Affairs was not able to give a straightforward solution to the taxation issues relating to international hiring-out of labor, the Report is still a useful tool in the battle against this specific type of international tax avoidance and evasion.

The description of various domestic solutions to tax (and social security) avoidance and evasion related to hiring-out of labor may be very useful information to countries which have as yet not felt the need to take action in this respect. However, the Committee did not indicate which solutions were preferable.

Why the Committee did not consider in its Report the often used specific provisions for frontier workers in bilateral tax treaties may be questioned.

Also, the emphasis put on the international exchange of information is not accompanied by considerations about the privacy of taxpayers. This right should at least be weighed against the legitimate attempts of tax authorities to stop tax avoidance and evasion.

Domestic legal provisions to enforce the payment of taxes levied abroad are a necessary prerequisite to an effective implementation of the forthcoming Multilateral Convention on Mutual Administrative Assistance in Tax Matters of the Council of Europe. It can be doubted whether liability for tax obligations of other taxpayers (for example employees or subcontractors), which is a part of the domestic actions to ensure taxation of hiring-out of labor, can be enforced by this means.

[continued from page 301]

concerned in the management of the affairs of the association or any person who was purporting to act in any such capacity shall be guilty of that offence as if he had himself committed it unless he proves that the act or omission constituting the offence took place without his knowledge, consent or connivance.

The penalty for a first offence is a fine of ₦ 2,000 or imprisonment for 6 months. The penalty for a second or subsequent offence is a fine of ₦ 3,000 or imprisonment for one year or both.

CONCLUSION

The Sales Tax Decree 1986 presents both positive and negative aspects. It is positive that it brings to an end a rather confused period in which each state went its own way often coming into conflict with the measures introduced by other states or with Federal regulations. The business concerns were always caught in the middle in these conflicts. From now on businessmen will clearly understand what their legal obligations are in this matter. The decision to collect the tax at the manufacturer or importer level can also be counted on the positive side. To try and use retailers as collecting agents would have been fraught with problems because of their great dispersion and leack of sophistication.

But also it is possible to anticipate some problems. Many Internal Revenue Departments lack the resources needed to monitor manufacturers or importers based in other states that are supposed to act as their collecting agents. At the very least some time will lapse before effective monitoring mechanisms entailing co-operation between different tax authorities are developed. In the meantime it can be expected that the sales tax receipts of some states may fall substantially. Serious problems are also posed to the business concerns charged with the duty of collecting the tax. It will be impossible in many cases to comply with the provision that stipulates that the tax must be collected not later than 30 days after the supply of any taxable goods or services. What the practical consequences of this will be remains to be seen. Another problem area for the collecting agents is the obligation imposed on them to collect taxes on behalf of 19 state governments and account in detail to each of them. In the Nigerian context it will certainly be difficult to do this. In fact, manufacturers have already publically expressed their misgivings in this connection.[10] Whether practical solutions to these problems can be devised without amending the Decree is subject to serious doubts.

10. See *Business Times* 5.5.86.

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40th Annual Congress of IFA: 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).

Management Centre Europe: Leasing (Training programme). Brussels (Belgium), 23-26 September (English).

IFA Singapore Branch: Congress paper review – tax residence/liquidations. Singapore, 25 September (English).

International Tax Planning Association: The protection and collection of information; Monte Carlo Workshop. Monte Carlo, Monaco, 25-26 September (English).

Bureau of European Taxation and Trade: The taxation of overseas partnerships in Europe (Symposium). London (U.K.), 29 September (English).

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Legal Studies & Services Ltd., IBC House, Canada Road, Byfleet, Weybridge, Surrey KT 14 7JL, United Kingdom.

Management Centre Europe, The Registrar, rue Caroly 15, B-1040 Brussels, Belgium.

CUMULATIVE INDEX 1986 – Nos. 1-6

Contents

of the August/September 1986 issue

SOMMAIRE

INHALTSVERZEICHNIS

Evidemment, la détermination de la résidence est de la plus haute importance pour la détermination de l'assujettissement à l'impôt. Jusqu'à la Loi sur la Réforme Fiscale américaine de 1985, le terme "résidence" était pluriinterprétable; néanmoins, à l'heure actuelle de nouvelles règles permettent une détermination nette du statut d'un contribuable. L'auteur donne un aperçu de la nouvelle loi et de son application et elle indique quelques possibilités de planification.

L'auteur revient sur un sujet qu'il a introduit en 1983 en esquissant les développements récents. Il traite la législation fédérale proposée, S. 1974 – en ce moment soumise à l'étude du Congrès – et il formule les conséquences probables de son exécution. M. Rothschild conclut que l'imposition unitaire est une espèce menacée.

Le système d'imposition unitaire a pour but de traiter les revenus gagnés à un certain endroit par une société dont la société mère réside aux Etats-Unis ou dans un autre pays de la même façon. Afin de maintenir cette égalité, des moyens raisonnables pour la répartition au niveau mondial sont nécessaires. L'auteur examine la formule de la quote-part et il commente les problèmes de change concernant les créances irrécouvrables, les amortissements d'emprunts et les transactions en devises, d'un point de vue national ainsi qu'international.

L'auteur donne une analyse succincte et clarifiante des problèmes fiscaux que les contribuables itinérants ou ayant plusieurs résidences peuvent avoir sous la législation fiscale actuelle des Etats-Unis. En outre, l'auteur fait des comparaisons aves quelques autres systèmes tels qu'ils sont appliqués à travers le monde.

L'auteur donne un aperçu des activités de la Chambre de Commerce Internationale, ainsi qu'elle présente sa position vis-à-vis de questions telles que; la Convention de l'Assistance Administrative Mutuelle dans le Domaine Fiscal réclamée par le Conseil d'Europe, l'harmonisation des lois fiscales à l'intérieur de la C.E.E., le système de l'imposition unitaire et les relations fiscales entre les pays développés et les pays en voie de développement.

L'auteur examine la jurisprudence récente en Australie, en développant ainsi à des fins fiscales la définition du revenu. L'auteur affirme que la jurisprudence récente ne cessera d'être attaquée, étant donné que les Australiens cherchent à récupérer les pertes subies à cause de la déflation du dollar australien, ce qui a mené à des pertes et des profits considérables.

L'auteur donne un aperçu des modifications apportées à la Loi de l'Impôt sur les Gains Pétroliers de 1959. Ensuite il analyse la détermination et l'imposition de taxes, les dégrèvements d'impôt sur le capital et d'autres dispositions essentielles relatives à l'imposition des gains pétroliers au Niger.

L'auteur considère la situation telle qu'elle s'est développée à Malte

Immobilien waren ausserordentlich komplex. Die neue Section 1445 IRC soll einige dieser Probleme mildern. Der Verfasser erläutert die verschiedenen Pflichten, denen die Veräusserer und Erwerber des Vermögens unterworfen sind, da sich der Rechtsstatus dieser Personen in jeder Transaktion ändert, wobei er den Hintergrund für die Einbehaltungspflichten erläutert.

Die Bestimmung der Ansässigkeit ist selbstverständlich von grösster Bedeutung, wenn es um die Prüfung der Steuerpflicht geht. Bis zum Steuerreformgesetz 1984 in den USA war dies eine Frage, die einen Ermessensspielraum liess; die neuen Bestimmungen aber ermöglichen nunmehr eine sehr genaue Bestimmung des Status eines Steuerpflichtigen. Die Verfasserin vermittelt einen Überblick über das neue Gesetz und seine Anwendung; gleichzeitig gibt sie einige Hinweise auf Gestaltungsmöglichkeiten.

Der Verfasser bezieht sich auf ein Thema, das er 1983 aufgegriffen hat, indem er über die zwischenzeitlichen Entwicklungen berichtet. Dabei geht er auf die vorgeschlagene Bundesgesetzgebung (S. 1974) ein, die sich derzeit im Kongress befindet, wobei er die zu erwartenden Auswirkungen beleuchtet. Herr Rothschild kommt zu dem Schluss, dass es sich bei Unitary Taxation um ein "gefährdete Art" handelt.

Der Zweck der Anwendung der Unitary Taxation soll darin liegen, die Einkünfte, die an einem bestimmten Ort bei einer Gesellschaft mit Hauptsitz in den USA oder einer solchen mit Hauptsitz in einem anderen Land anfallen, gleich zu besteuern. Um diese Gleichheit zu schaffen, müssen vernünftige Schlüssel für die weltweite Aufteilung herangezogen werden können. Der Verfasser erläutert zunächst die Aufteilungsformeln, um danach die Währungsprobleme zu untersuchen, die im Zusammenhang mit der Berücksichtigung zweifelhafter Forderungen entstehen können; schliesslich nimmt er zu Fragen der Rückzahlung von Anleihen und Devisentransaktionen Stellung, und zwar aus inländischer als auch aus ausländischer Sicht.

Der Verfasser legt einen kurzen und aufschlussreichen Überblick über die Steuerprobleme vor, die Steuerpflichtige mit mehreren Wohnsitzen oder ohne ständigen Aufenthalt nach den gegenwärtigen Bestimmungen des US-Steuergesetzes bekommen können. Daneben werden Vergleiche mit mehreren anderen Systemen angestellt, wie sie in anderen Staaten angewandt werden.

Die Verfasserin vermittelt einen Überblick über die Aktivitäten der Steuerkommission der Internationalen Handelskammer, wobei sie deren Standpunkt zu folgenden Fragen präsentiert: zur Konvention über die gegenseitige Amtshilfe der Steuerbehörden, wie sie vom Europarat gefordert wird, die Harmonisierung der Steuergesetze innerhalb der Europäischen Gemeinschaft, Unitary Taxation sowie die steuerlichen Beziehungen zwischen Entwicklungsländern und Industriestaaten.

Der Verfasser gibt zunächst einen Überblick über das kürzlich gesprochene Richterrecht in Australien bezüglich der Definition des Begriffs "Einkommen" für Steuerzwecke. Diese kürzlich entschiedenen Fälle werden wiederum Anlass zum Streit bieten, wenn die Steuerpflichtigen in Australien versuchen werden, die Verluste mit

Special Thanks

The Bureau and the staff for the *Bulletin for International Fiscal Documentation* would like to express their special gratitude for the efforts of W. Scott Thomas of Brobeck, Phleger & Harrison, San Francisco, California. Mr. Thomas, a past editor of Bureau publications, contacted, organized, and directed the preparation of this IFA issue for 1986. We are honored to have him as a correspondent for the *Bulletin* and look forward to many more years of Mr. Thomas' assistance.

Subjects and Seminars of the IFA Congress 1986

Subject I
Transfer of assets into and out of a taxing jurisdiction

Subject II
Currency fluctuations and international double taxation

Seminar A
Taxation of domestic shareholders on undistributed income of foreign corporate affiliates; objectives, techniques, and consequences

Seminar B
International tax treatment of common law trusts

Seminar C
Issues in state and local taxation in the United States

Seminar D
Taxation of income from investments in United States real property by foreign persons after the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA) and 1984 withholding amendments

Sujet I
Transfert d'actifs vers et hors d'une juridiction fiscale

Sujet II
Fluctuations de change et double imposition internationale

Séminaire A
Imposition des actionnaires résidents à raison des bénéfices non-distribués des sociétés étrangères affiliées: objectifs, techniques et conséquences

Séminaire B
Traitement fiscal international des trusts anglo-saxons

Séminaire C
Problèmes de l'imposition au niveau des Etats fédérés et des communes aux Etats-Unis

Séminaire D
Imposition des non-résidents sur les revenus de propriétés immobilières aux Etats-Unis; législation récente Foreign Investment in Real Property Tax Act of 1980 (FIRPTA) et retenues à la source, amendements de 1984

Thema I
Transfer von Wirtschaftsgütern in eine und aus einer Steuerhoheit

Thema II
Wechselkursänderungen und internationale Doppelbesteuerung

Seminar A
Die Besteuerung inländischer Aktionäre mit den nicht ausgeschütteten Gewinnen verbundener ausländischer Kapitalgesellschaften: Ziele, Verfahren und Folgen

Seminar B
Die Behandlung des angelsächsischen Trusts im internationalen Steuerrecht

Seminar C
Steuerprobleme auf der Ebene der Bundesstaaten und Kommunen der U.S.A.

Seminar D
Besteuerung des Einkommens von Ausländern aus Immobilienbesitz in den U.S.A. nach dem Foreign Investment in Real Property Tax Act von 1980 (FIRPTA) und der Quellensteuernovelle von 1984

Tema I
Transferencia de activos dentro y fuera de una jurisdicción fiscal

Tema II
Fluctuaciones monetarias y la doble imposición internacional

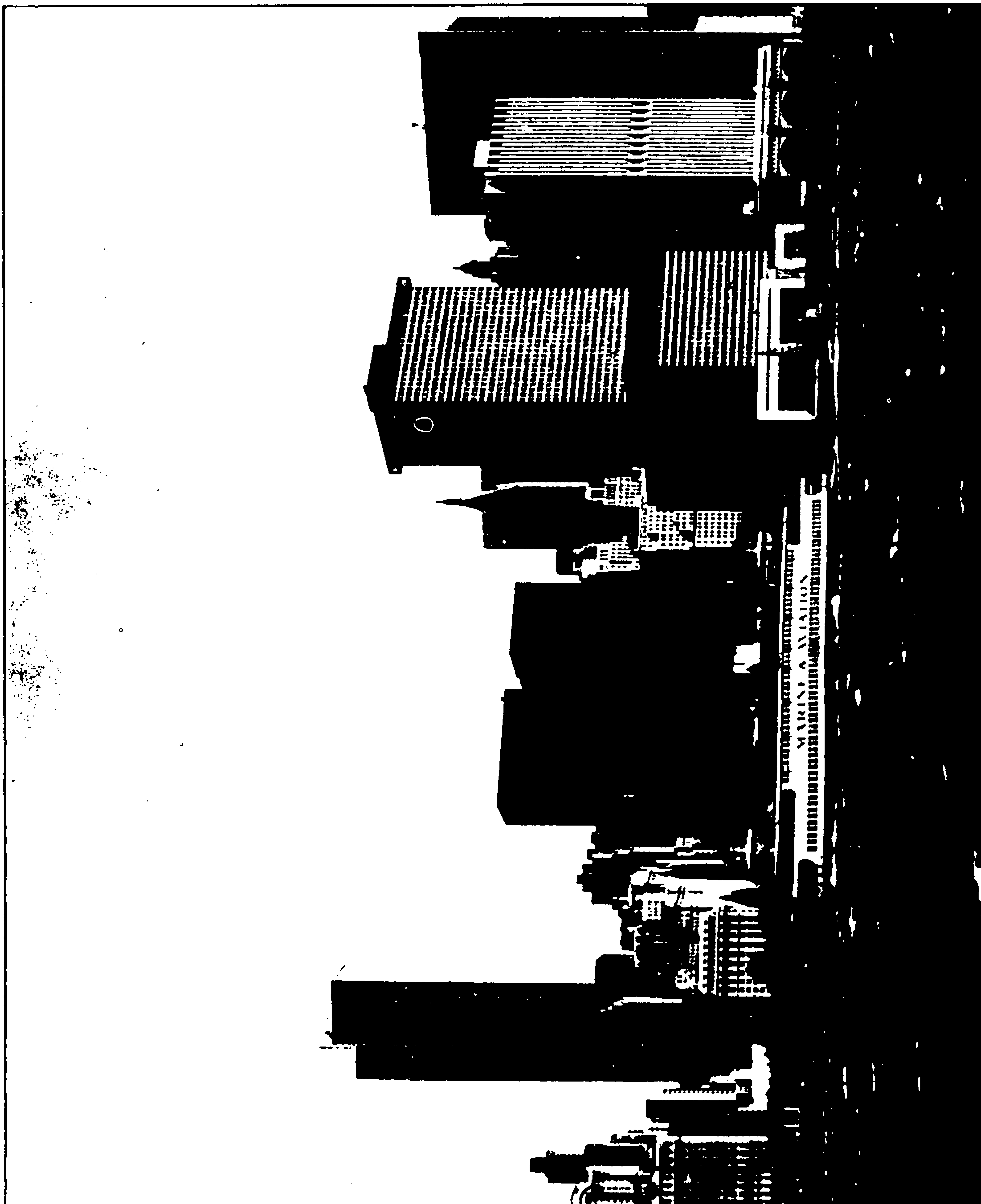
Seminario A
Tributación de los accionistas nacionales sobre los rendimientos no distribuidos de sociedades filiales extranjeras: objetivos, técnicas y consecuencias

Seminario B
Tratamiento fiscal internacional de los trust anglosajones

Seminario C
Objetivos en la tributación estatal y local en los Estados Unidos de America

Seminario D
Tributación sobre los rendimientos de las inversiones de extranjeros en propiedades inmobiliarias de los Estados Unidos después de la ley sobre propiedad inmobiliaria de 1980 (FIRPTA) y de las enmiendas de 1984 sobre retenciones

CONGRESS 1986 — NEW YORK



New York Congress 1986

IFA comes to North America for the fourth time, the U.S. for the second, and New York for the first. This will be my first full Congress as president, and as a native New Yorker the occasion has special meaning for me.

London will be a tough act to follow – the British Museum and the Barbican Centre are superb attractions, and those who attended the special performance of Richard III will never forget it – the Royal Shakespeare Company at its best. But even frequent business travelers to New York will find the United Nations and the Metropolitan Museum of Art unique and fascinating as Congress meeting sites (places you always meant to visit but never had the time). Frequent theatre-goers will be surprised to see the brand new Marriott Marquis Hotel rising above Broadway (as part of a massive redevelopment of Times Square). And sports fans will be interested that the Seventh Regiment Armory (site of the Gala) was the venue of the U.S. indoor tennis championships for many years.

The New York Congress excursions will have to stretch to equal the Gaucho festival of the Buenos Aires Congress, but, among others, there are two programs special to New York that should be a match: an excursion to Harlem (a cultural center in New York) and an ethnic tour of New York – the melting pot.

The technical subjects for discussion at the New York Congress are timely. As cross-border investment and trade increase, and as the industrial countries in particular are more vigilant of tax avoidance by multinational groups, the first subject – transfer of assets into and out of a taxing jurisdiction – becomes increasingly important both to taxing jurisdictions and to taxpayers. And the second subject – currency fluctuations and international double taxation – cries out for attention when even benchmark currencies fluctuate 10 or 20% or more against each other in a matter of months (the current state of the U.S. dollar is a welcome change for many attending the Congress). Currency fluctuations were previously dealt with at the 1972 Congress in Madrid, so a reconsideration at this time – in light of the frequent and massive currency movements that have occurred since – is quite appropriate. IFA Congresses have not previously considered asset transfers as such.

All four technical seminars are current and topical. Two deal with discretely U.S. subjects: (1) state and local taxation in the U.S. and (2) taxation of investments by foreigners in U.S. property. The former, as it includes in its scope the California unitary squabble, may well be one of the most exciting presentations at the Congress from the standpoint of airing of passionately held conflicting viewpoints. As I write this, the California legislature is still considering remedial legislation; but even should such legislation be enacted, the general topic of state taxation is an important consideration to the potential foreign investor in the U.S. – a consideration that is often overlooked.

A third seminar, on taxation of unremitted earnings of foreign corporate affiliates, does not pertain just to U.S. taxpayers, but we are reminded that it was the U.S. that first brought the concept into practice 23 years ago with its Subpart F legislation. The concept has now spread to *seven* countries. The fourth seminar is on the international taxation of common law trusts.

Richard M. Hammer
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 Committee 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).

The General Reporters have done an excellent job soliciting, distilling, and reporting valuable information. And the General Reports are generous in noting the thoughtful and detailed responses of the National Reporters. To all these people, we are grateful for their efforts.

From the standpoint of international double taxation (or, perhaps, unfair taxation), Subject I ("the transfer of assets into and out of a taxing jurisdiction") raises many serious problems and issues (the General Reporter is Yann Kergall of France). A simple example is the transfer of an asset by Country A Corp. to its subsidiary Country B Corp. If Country A treats the transfer as a sale at fair market value (and taxable as such), but Country B deems Country B Corp. to take a carryover (substitute) basis, the potential for double taxation is obvious and the result is inequitable.

The same type of issues also arise from the recent practice of floating (literally) multi-million dollar drilling platforms into a jurisdiction, depreciating them for a period of time, and floating them back out of the jurisdiction to another jurisdiction.

Transfer of technology has become a widespread phenomenon, and in its wake has created tax issues and obstacles. For example, as a matter of tax policy, most countries permit immediate write-offs of technology development (so-called R&D) as an incentive measure, and they are reluctant to see the technology transferred abroad tax-free before exploitation at home. The U.S., which already has strong laws in place in this area, is now considering tax reform which includes a provision that, in effect, would require an annual adjustment to a royalty between a U.S. licensor and a related foreign licensee to reflect the increasing market value of the licensed intangible property right. This provision, which makes a mockery of the arm's-length standard, comes on top of the 1984 amendment which effectively prevents a transfer of technology to a foreign affiliate other than in an arm's-length sale or license arrangement. I am happy to say that the floating rate adjustment amendment seems, at the time of writing, to have fallen from favor.

The General Reporters on currency fluctuations (Marianne Burge and Paul Farber of the U.S.) conclude that the National Reporters see the lack of firm tax rules as a more significant problem than that of double taxation. One anomaly noted is that, under U.S. rules – because Subpart F deemed dividends are translated on a different basis than are actual dividends – the foreign tax credit as calculated under Subpart F is more favorable than the calculation for an actual dividend, at least in years when the U.S. parent has an exchange loss in a foreign subsidiary.

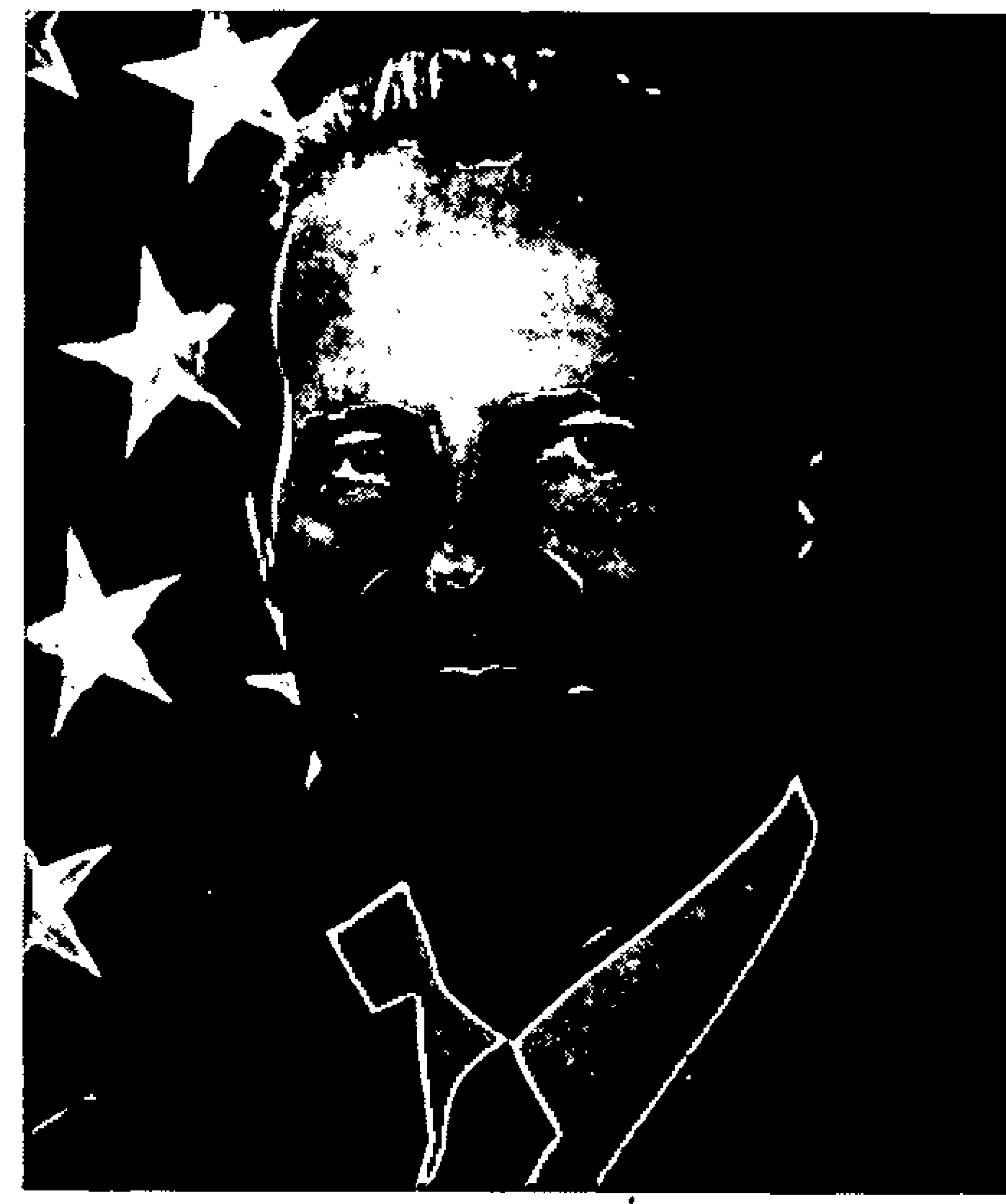
Many of the National Reporters feel that exchange fluctuations should result in business deductions and income, rather, than in many cases, being tied to archaic concepts of capital versus business loans or transactions.

In both cases the General Reports give excellent summaries of the current state of affairs in both subject areas.

On behalf of the General Council, the Executive Committee, the Secretary-General, the Treasury-General, the Permanent Scientific Committee, and myself, I want to express heartfelt gratitude to the U.S.A. Branch and, in particular, the organizing committee for orchestrating what promises to be an exciting and great Congress!

Some Reflections on Tax Reform in the U.S.A.

Statement by Secretary of the Treasury James A. Baker, III for the Congress of the International Fiscal Association



Tax reform is picking up momentum worldwide. Many nations are joining the United States in realizing that high tax rates often impede economic growth and weaken confidence in government. Marginal rates have gone higher and higher for increasing portions of the population. And as tax preferences have proliferated, rates have risen to compensate.

This certainly has been the experience of the United States. Since its inception in 1913, a simple income tax has evolved into a massive system that is unfair, too complicated, and discourages economic growth. But over the last two years, the United States has worked steadily at comprehensive reform that would dramatically lower rates and broaden the tax base.

The current code is the unfortunate result of countless well-intentioned efforts to solve economic and social problems through the tax system. Decisions about spending, investment, working, business organization, and business finance are frequently made on the basis of tax considerations. Such influence is not obvious, but is just as inefficient as more overt governmental intervention into the economy.

The high rates dampen growth in several ways. They strongly discourage personal savings, work effort, and business investment. They are compelling incentives for evading taxes or investing in legal tax shelters.

As accountants know, the shelter investments have little, if any, payoff in pretax dollars but ultimately yield handsome returns at the expense of taxpayers in general. And tax benefits often hurt those they seek to help. By creating unintended excesses of supply, they have led to turbulence and bankruptcies in such industries as farming and real estate.

Most ominously, our flawed system threatens our national values. President Reagan recently noted that every time a government begins taxing above a certain level of people's earnings, trust in the government erodes. The belief that others are paying less than their fair share intensifies. Efforts to avoid paying tax spread. Outright cheating, and eventually a distrust and contempt of government itself, follow.

When we in the United States began our tax reform effort, a poll reflected Americans' deep dissatisfaction with the tax system. According to the survey:

- 4 of 5 taxpayers believed the tax system benefitted the rich and was unfair to the ordinary man or woman;
- a majority of taxpayers believed the federal income tax system was too complicated; and
- a majority perceived that cheating on income tax was rampant.

James A. Baker, III became the 67th Secretary of the Treasury on 3 February 1985.

Prior to this Secretary Baker had been appointed by President Reagan as Chief of Staff to the President of the United States, a position which he occupied from January 1981 through January 1985. While at the White House he was a member of the National Security Council and remains a member as Secretary of the Treasury. He is also Chairman of the President's Economic Policy Council.

In 1980, Secretary Baker served as Senior Adviser to the Reagan/Bush general election campaign. From January 1979 to May 1980 he was the Chairman of Vice President Bush's campaign for the 1980 Republican Presidential nomination.

Secretary Baker was the Republican Party's nominee for Attorney General of the state of Texas in 1978. He is a native Houstonian and practiced law there with the firm of Andrews Kurth from 1957 to 1975.

In August 1975, Secretary Baker was appointed by President Ford to be the Under Secretary of Commerce. Secretary Baker joined President Ford's presidential campaign in May 1976 as Deputy Chairman for Delegate Operations and in August became National Chairman of the President Ford Committee.

We believe it is of paramount importance that our system be permanently reformed. Halfway efforts must be avoided. We must remember that many of the piecemeal "reforms" of the past are responsible for the problems of today.

These thoughts were on the President's mind when he proposed a brand new tax system last year. The Congress took up the challenge and over the last year has made significant steps. As this meeting of the International Fiscal Association convenes, I hope that historic tax reform will have been enacted by the U.S. Congress and signed into law by the President.

Although the particulars are still under consideration by the Congress as of this writing, the President has established strong and bold guidelines for a tax reform that would be acceptable to him. They include the following:

- tax rates for individuals and corporations must be dramatically lower;
- basic incentive for investments in American industry must be retained;
- there must be a minimum tax which allows no individual or business to escape paying a fair share of the overall tax burden; and
- any changes in the tax law must be revenue-neutral, neither raising nor lowering total tax revenues.

Carrying out these principles means sweeping changes in the tax system. Only if many tax preferences are eliminated can we reduce rates sharply. If this is done, we quite possibly would have top rates that are lower than those of any other developed country.

With reform the sun would begin to set on unproductive tax shelters. Buildings would no longer be erected only to stand vacant – the so-called "see-through" buildings. Investors would have less reason to invest in farm property that is expected to lose money.

As the unfairness in the tax system is rooted out, we hope for a reinvigoration of the American notion that success should be limited only by one's willingness to work hard, and a renewal of confidence in the ability of our nation's leaders to govern for the general interest rather than the special interest.

The United States is not alone in pursuing the benefits of fundamental tax reform. The United Kingdom, Canada, Japan, Australia, New Zealand, the Scandinavian countries, and other developed countries have moved, in varying degrees, toward such reform.

The tax reform spirit is also catching on in developing countries. Nowhere is there a greater need for efficient revenue-raising systems that allow economies to grow freely. India is implementing tax reforms that substantially reduce tax rates. Bolivia, in a courageous effort to address its essential revenue needs, is adopting a new tax structure.

These efforts toward fundamental tax reform can benefit from the sharing of experience and technical knowledge – a sharing that is fostered by the International Fiscal Association. Even more important are the contributions that this organization makes to improved international understanding and cooperation. It is with great pleasure that we welcome you to the United States.

Secretary Baker graduated from Princeton University in 1952. After two years of active duty as a Lieutenant in the United States Marine Corps he entered the University of Texas School of Law at Austin. He received his J.D. with honors in 1957.

A member of the American, Texas and Houston Bar Associations, the American Judicature Society, and the Phi Delta Phi honorary legal fraternity, Secretary Baker also serves on the Board of Trustees of the Woodrow Wilson International Center for Scholars at the Smithsonian Institution. He has served on the governing bodies of the Texas Children's Hospital and the M.D. Anderson Hospital and Tumor Institute.

Secretary Baker has been the recipient of the Jefferson Award for distinguished public service from the American Institute for Public Service, an award for Distinguished Public Service from the John F. Kennedy School of Government at Harvard and the Woodrow Wilson Award for distinguished achievement in the nation's service from Princeton University. Secretary Baker was selected in 1986 as a Distinguished Alumnus of the University of Texas. He has received numerous honorary degrees.

Secretary Baker was born 28 April 1930. He and his wife, the former Susan Garrett, reside in Washington, D.C. They have eight children.

Resolving Tax Treaty Issues: A Novel Solution *

By Joseph H. Guttentag and Ann E. Misback

Mr. Guttentag practices law in Washington, D.C. and specializes in the field of international trade and taxation. He served in the late 1960s in the position now known as International Tax Counsel for the Treasury Department, and was also appointed as Adjunct Professor of Law at Howard University and Professorial Lecturer at George Washington University. He is a consultant to the Project on International Aspects of U.S. Income Taxation of the American Law Institute. He has served as Chairman of the Committee on Foreign Tax Problems of the Section of Taxation, American Bar Association, and as a member of the Taxation Committee of the Chamber of Commerce of the United States. He is a member, and served as Chairman, of the Task Force on International Tax Policy of the Chamber. He lectures frequently on international tax and trade matters and recently before such groups as the Japanese Institute on International Business Law, the Canadian Branch of the International Fiscal Association, and the Tax Executives Institute in the United States.

He received his A.B. from the University of Michigan and his LL.B. *cum laude* from Harvard Law School, where he was an editor of the Harvard Law Review. He is a member of the Bars of the District of Columbia and Michigan.

I. INTRODUCTION

Tax conventions have traditionally provided for designated tax officials of each of the countries, *competent authorities*, to resolve issues arising under the convention through mutual agreement. These issues fall into two broad categories: interpretive questions of general applicability and problems specific to a particular taxpayer. The most common examples of the latter category are transfer pricing issues and related tax compliance matters. Failure of the competent authorities to agree leaves the issues unresolved or resolved unilaterally, and possibly differently, through administrative and judicial procedures established under the municipal law of each of the treaty partners. Accordingly, double taxation can result or there can be different interpretations of the treaty by the taxing authorities of each of the countries.

Germany and Sweden have taken a novel approach to this problem in a proposed new tax convention (Treaty) initialled about a year ago, but not yet in force.[1]

Article 44 of the Treaty expands upon the standard mutual agreement procedures. It provides new procedures for resolving disagreements when the competent authorities are unable to do so. By making the European Convention, as of 29 April 1957, for the Peaceful Settlement of Disputes applicable to tax matters, Article 44 provides access to both the International Court of Justice and Arbitration. Article 44 provides access to both the International Court of Justice and Arbitration. Article 44 is an interesting development worthy of further study by treaty countries, taxpayers, and their advisors.

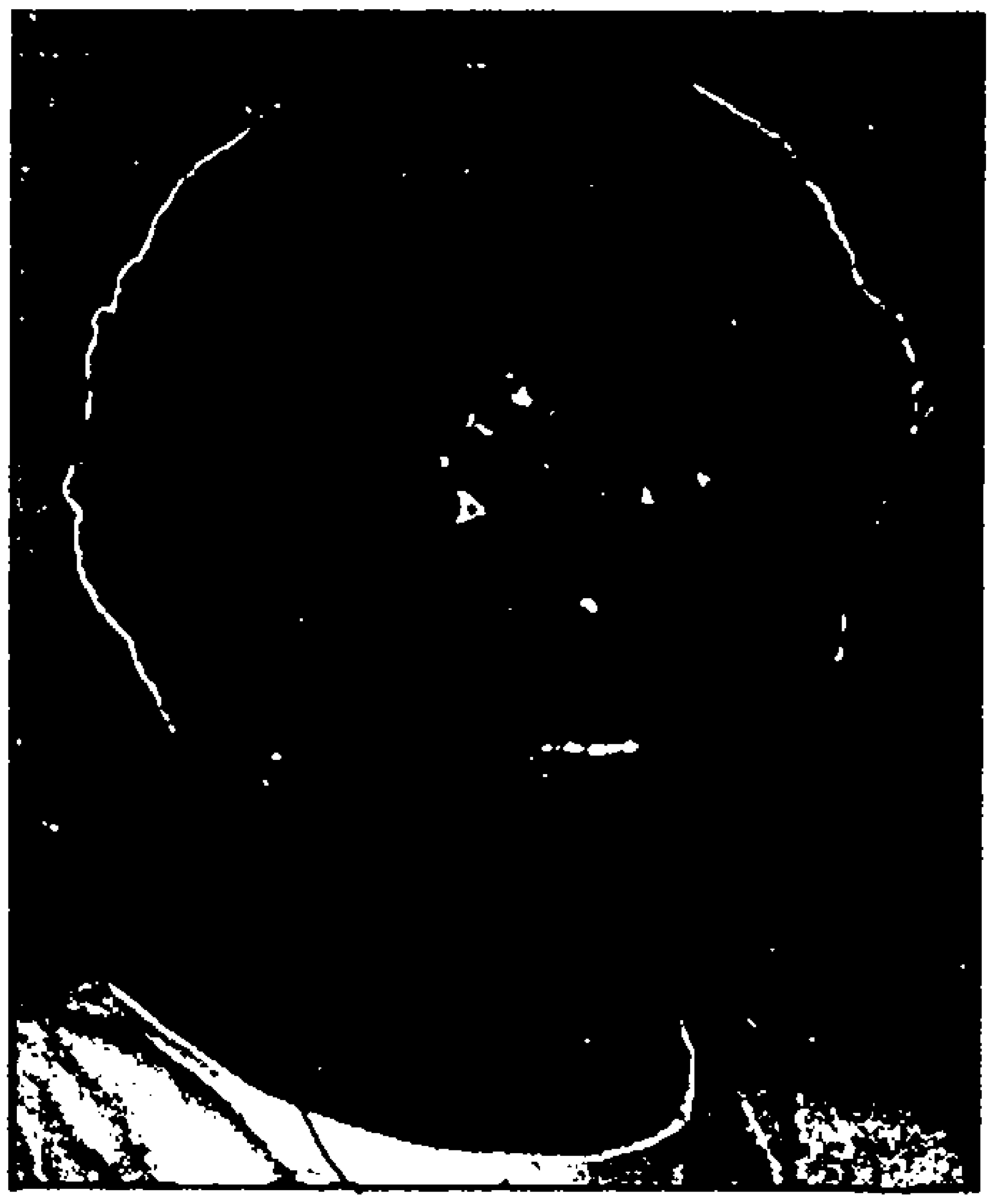
II. CURRENT MUTUAL AGREEMENT PROCEDURES

Tax treaties based on the 1977 OECD Model Double Taxation Convention on Income and Capital (1977 OECD Model), the United States Model Tax Treaty of 17 May 1977 (1977 U.S. Model) and the United States Draft Model Tax Treaty of 16 June 1981 (1981 U.S. Model) generally contain mutual agreement procedure clauses. The 1977 Model clause[2] gives a taxpayer in either Contracting State who considers that the actions of one or both Contracting States result or will result in double taxation or taxation not in accordance with the convention a remedy in addition to any domestic law remedy.

Once the taxpayer asserts his claim to the appropriate competent authority, the competent authority attempts to reach a satisfactory solution unilaterally, provided he believes the claim is justified. If he is unable to do so, the competent authorities of the two Contracting States endeavor to reach a mutual agreement. The competent authorities may also consult together for the elimination of double taxation in cases not provided for in the applicable convention. Tax conventions based upon the 1977 OECD

* This article comments on provisions of a proposed German–Swedish tax treaty which provides for resolution of treaty interpretations and other issues by arbitration and other means.

1. 19 Tax News Service No. 14 (31 July 1985).
2. See Appendix I.



Ms. Ann E. Misback graduated from Princeton University in 1979. Thereafter she studied law at Georgetown University Law Center, receiving her J.D. in 1983. Ms. Misback clerked for the Honorable Judge Herbert F. Murray, United States District Court for the District of Maryland from 1983-85. Since leaving that position, she has been an associate in the firm of Arnold & Porter, Washington, D.C.

Model permit the competent authorities to communicate with each other directly without going through normal diplomatic channels, thus avoiding domestic law secrecy restrictions which might otherwise apply.

Cases presented by a taxpayer may involve factual issues (e.g. the question of the "correct" transfer price), legal issues (e.g. in which country does certain income arise?), or both types of issues may be combined in one case. Cases raised by the competent authorities are more likely to involve convention interpretation or other legal issues rather than factual issues. For example, one issue which the U.S. competent authority is attempting to solve on a bilateral basis is the treatment of interest on deficiencies and refunds in transfer pricing and similar cases.

The mutual agreement procedures in the 1977 and 1981 U.S. Models are virtually identical to one another and differ only slightly from the corresponding provision in the 1977 OECD Model.[3] The differences between the model drafts primarily involve procedural rules. For example, the United States–Canada treaty contains a provision which prohibits adjustments or tax by one Contracting State based on related party transactions unless notification is given to the competent authority of the other State within six years from the end of the year involved.[4] The 1977 OECD Model, however, requires presentation of a case within three years of the date the taxpayer receives notification of potential double taxation. The U.S. Models specify the issues on which the competent authorities may agree. The 1977 OECD Model makes no attempt to particularize areas of potential agreement.

A significant element in all of these models is the absence of any provision requiring the competent authorities to reach an agreement or providing an alternative dispute resolution procedure should they fail to do so. The mutual agreement provisions in the United Nations Model Double Taxation Convention Between Developed and Developing Countries also suffer from the same omission.[5] A number of commentators have criticized this lack of compulsory dispute resolution procedures.[6] It is not clear, however, that the lack of such procedures presents a significant problem in practice.

Statistics for the United States competent authority program indicate that the program has resolved a high percentage of its cases. However, the volume of cases, particularly multi-country cases, is growing, as is the time required to resolve them. The United States has had better success in resolving income allocation cases, primarily involving transfer pricing, than non-allocation issues. The U.S. competent authority has stated that since 1970, 67% of *all* its allocation cases have been resolved with full relief to the taxpayers. An additional 8% received partial relief. When only cases in which the procedure was carried to conclusion are counted (74% of all allocation cases), 80% of the taxpayers were granted full relief, and 10% partial relief. The figures for all non-allocation cases were 54% full relief and 7% partial relief.[7] These data should be considered when evaluating the dispute resolution procedures in the Treaty. Even though most cases may be adequately resolved, important unresolved issues which could affect treaty relationships or cases which have a significant impact on a taxpayer might be appropriate for third-party resolution. Furthermore, the increasing number of multi-country transfer pricing cases may lend themselves to such procedures.

3. See Appendix II.
4. Convention with respect to Taxes on Income and Capital, 17 September 1983, United States–Canada, 28 U.S.T. 1134, T.I.A.S. 8499, Art. IX.
5. See Appendix III.
6. See e.g. Avery-Jones et al., "The Legal Nature of the Mutual Agreement Procedure Under the OECD Model Convention II", 1 *British Tax Review* 13, 19 (1980) (Avery-Jones).
7. U.S. Competent Authority, Transfer Pricing and Other International Issues (unpublished paper submitted to International Tax Institute, Inc. 25th Anniversary Seminar, New York City, 2-3 June 1986). Presumably, these statistics are based on the number of cases involved and not U.S. dollar amounts.

III. TEXT OF ARTICLE 44

The following is an unofficial translation of the expanded procedures in Article 44 of the Treaty.

Art. 44 Procedure[8]

(1) The competent authorities of the Contracting States may communicate with each other directly for the purpose of reaching an agreement under Articles 42 and 43.[9]
(2) Where a personal consultation seems appropriate to reach an agreement, such consultation may be conducted by a commission consisting of the representatives of the competent authorities of the Contracting States.
(3) The competent authorities may jointly retain an independent panel to give a legal opinion on such matters as directed to the panel.
(4) Where the procedure deals with the case of a single taxpayer, the latter will be granted a hearing; he does also have the right to propose a motion.
(5) Regarding the solution of conflicts under International Law resulting from this Convention, the European Convention as of 29 April 1957 for the Peaceful Settlement of Disputes does apply. The Contracting States may agree, however, instead of the procedure stipulated therein upon a Court of Arbitration, whose decision will be binding for the Contracting States. This Court shall consist of judges of the courts of the Contracting States or of third countries or of international organizations. Its procedure will be in accordance with internationally recognized principles of arbitration procedures. The parties concerned shall have the right to completely present their case and propose their own motions. The decision will be based upon the treaties of the Contracting States and the general international law; a decision ex aequo et bono is inadmissible. Until the time it has been agreed upon the invocation and the formation of the Court of Arbitration as well as upon its procedure, each Contracting State may proceed under Sentence 1.

The first two paragraphs of Article 44 are similar to some provisions in the standard mutual agreement procedure. Paragraph 1 is identical to the corresponding sections of the mutual agreement procedure in the 1977 OECD Model and the U.S. Models. Paragraph 2 permits personal consultation through a commission consisting of representatives of the competent authorities. The corresponding section of the 1977 OECD Model limits such consultation to the exchange of oral opinions.

The remaining paragraphs in Article 44 significantly expand the mutual agreement process. Paragraph 3 gives the competent authorities permission to retain an independent panel to give legal opinions. The paragraph does not indicate how panel members are to be selected. Presumably, any opinion would be confined to the interpretation and application of the treaty between the Contracting States and points of general International Law. Paragraph 4 should be of special interest to taxpayers and practitioners. It gives a taxpayer the right to file motions and to have a hearing before the competent authorities.

Paragraph 5 contains the most far-reaching and likely controversial innovation. It provides that "conflicts under International Law" which result from the Treaty will be resolved through the procedures set out in the European Convention for the Peaceful Settlement of Disputes, 29 April 1957, No. 4646, 320 U.N.T.S. 243 (European Convention) or by a Court of Arbitration. The European Convention provides for reference of disputes regarding treaty interpretation to the International Court of Justice (ICJ) and for reference of other types of disputes to conciliation or arbitration. The arbitration process contemplated in Article 44 differs from the arbitration procedures set out in the European Convention. Article 44 provides for an Arbitration Court composed of judges of the courts of the Contracting States, third countries, or international organizations. The Arbitration Court is to follow unspecified, internationally recognized arbitration procedures. The parties to the dispute will have the right to present their case and propose motions. Any decision the Arbitration Court reaches must be based on treaties and general international law. A decision based on equitable principles is not permissible.[10]

IV. STATUS OF THE TREATY

Neither Germany nor Sweden has ratified the Treaty. The parties may disagree over the nature of the Article 44 procedures and these procedures may be modified prior to ratification. For example, the World Court/arbitration provisions appear to be mandatory, but it is understood that Sweden takes the position that they are not. Germany believes that only the rare case will require arbitration proceedings and cases heard would principally present legal rather than factual issues. The parties would select up to nine judges, three from the highest fiscal courts of each jurisdiction, who would then select three from other countries. Under the current draft only a contracting party may invoke the procedure, but it is possible that subsequent versions might permit taxpayer invocation.[11]

Presently, there are no other tax treaties with comparable dispute resolution clauses. Germany continues to favor the inclusion of such clauses and has been attempting to have similar provisions included in other treaties. It is possible that an arbitration clause will appear in its future bilateral tax treaty with the Netherlands.

8. The drafters appropriately did not refer to "mutual" or "agreement" since decisions made by third parties would be neither.
9. Article 42 of the treaty governs consultation in single cases and Article 43 contains a version of the first three paragraphs of the standard mutual agreement procedures in Article 25 of the 1977 OECD Model.
10. This language may reflect a concern that if certain cases such as transfer pricing cases were to be heard by an arbitration court, extreme positions might be taken by each side with the expectation that the court, faced with the difficulty of determining an "arm's-length" price, might opt for an "equitable" solution. Some critics have asserted that U.S. courts faced with these issues adopt such a solution.
11. T. Menck, Federal Ministry of Finance, FRG, Remarks at International Tax Institute, Inc. 25th Anniversary Seminar, New York City, 3 June 1986.

V. DIFFERENT PERSPECTIVES

The idea of creating forums in which international tax disputes can be resolved is not new. The commentary to Article 25 of the 1977 OECD Model recognizes the problem.

> [T]he competent authorities are under a duty merely to use their best endeavours and not to achieve a result. However, Contracting States could agree on a more far-reaching commitment whereby the mutual agreement procedure, and above all the discussions in the Joint Commission, would produce a solution to the dispute. Such a rule could be established either by an amendment to paragraph 2, by an interpretation specified in a protocol or an exchange of letters annexed to the convention.[12]

The commentary goes on to suggest the possibility of reference of disputes to third-party arbitrators.[13] Commentators and international organizations, however, hold different views on the need for arbitration.

The European Economic Community has proposed the establishment of arbitral bodies to resolve double taxation issues. One commentator argues that such arbitral courts are

> a natural extension of the two country committee procedure currently available under most OECD-based treaties.[14]

Similarly, both the International Chamber of Commerce[15] and the Institute of German Chartered Accountants[16] have indicated their support for reference of international tax disputes to arbitration. All of these bodies have stated that arbitration should be available in transfer pricing cases. One commentator proposes that taxpayers have a right to plead their case before a joint panel of competent authorities that represent nations affected by a proposed adjustment.[17] At least two others have called for ICJ resolution of tax disputes.[18]

The OECD Committee on Fiscal Affairs has also considered the advisability of adding arbitration provisions to double taxation treaties. In a report issued in 1984, the Committee specifically chose not to recommend the adoption of compulsory arbitration procedures to supersede or supplement the mutual agreement procedure.[19] Until the initialling of the Treaty, governments similarly have been unwilling to include provisions for compulsory dispute resolution in their double taxation treaties.[20]

The United States would likely find such provisions troublesome. Tax conventions must receive the advice and consent of the U.S. Senate in order to be ratified. United States lawmakers, courts, and Government officials often presume the correctness of U.S. statutory law and judicial precedents when considering tax conventions with apparent inconsistent provisions. This domestic perspective does not vary significantly with the type of treaty issue involved and is admittedly inconsistent with the notion of referring bilateral tax disputes to international tribunals and the application of international law to such disputes. For example, the Congress has often considered, and several times approved, legislation which overrides treaty provisions.[21] In addition and in contrast to legislative bodies in many other countries, particularly those countries with parliamentary systems, the U.S. Senate does not consider tax conventions to have major significance. The Senate has often subjected proposed tax conventions to long delays or significant reservations, though outright rejection has been rare.

United States courts sometimes share this attitude toward tax conventions. American courts, when asked to interpret a bilateral tax convention in a suit involving a U.S. taxpayer, will sometimes not consider the interpretation the treaty partner would give to the particular provision in issue.[22] Courts of other countries may take the same approach.[23]

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12. M. Edwards-Ker, *The International Treaties Service* (1977) at Art. 25, p. 6.
13. Id. at Art. 25, p. 9.
14. Eiker, "Competent Authority: At Home and Abroad," 5 *Int'l Tax J.* 198, 213 (1979).
15. Int'l Chamber of Commerce, "The Resolution of International Tax Conflicts", 24 *European Taxation* 337 (1984).
16. Institut der Wirtschaftsprüfer, "Statement on the OECD Report of 6 July 1982 on Transfer Pricing, Corresponding Adjustments and the Mutual Agreement Procedure", 39 *Bulletin for International Fiscal Documentation* 461 (1985).
17. J. McDermott, Twenty Five Years of International Tax Law – And the Future (unpublished paper submitted to International Tax Institute, Inc. 25th Anniversary Seminar, New York City, 2-3 June 1986).
18. See Comment, "The Competent Authority Concept in United States Tax Treaties", 2 *Law & Policy International Business* 232 (1970).
19. Organization for Economic Cooperation and Development, *Transfer Pricing and Multinational Enterprises: Three Taxation Issues* (1984) at 38.
20. Avery-Jones, supra note 7, at 19.
21. Tax legislation recently has been pending in the Congress which, if enacted, would override the non-discrimination clauses in numerous double taxation treaties. Legislative proposals include the imposition of a branch tax on U.S. branches of foreign companies, denial of deductions for certain interest paid to related foreign companies by U.S. companies, and restrictions on "dual resident" companies.

A section of the Senate Foreign Relations Committee's report recommending the ratification of the Tax Convention with Barbados, S. Treaty Doc. No. 3, 99th Cong., 1st Sess. (1985), is illustrative.

> The Committee wishes to make clear that, in recommending Senate approval of the proposed treaty at a time when Congressional efforts to achieve major tax reforms are underway, the Committee expects that Congress' flexibility in the tax reform process will not be restricted by the treaty. . .
>
> Congress might find it necessary to exercise its prerogative to override some provisions of treaties, including those recently ratified, that are in conflict with the reforms. Therefore, although the Committee decided not to recommend a formal reservation or understanding with respect to this issue, it does wish to emphasize to our prospective treaty partners that if Congress decides to enact a dividends paid deduction, Congress may not defer to the contrary provisions of any treaty in so doing.

S. Exec. Rep. No. 9, 99th Cong., 1st Sess. (1985).

22. See e.g. *Boulez* v. *Comm'r*, 83 T.C. 584 (1984) (a case involving an orchestra conductor where competent authorities could not agree, the Tax Court noted but gave no weight to German interpretation of U.S.–German tax treaty provision on royalties); *The Great-West Life Assurance Co.* v. *United States*, 82-1 U.S.T.C. ¶ 9374 (Ct. Cl. 5 May 1982) (a case involving U.S.–Canada tax treaty, Court did not refer to any Canadian interpretation of Article XII interest exemption); but see *Coplin* v. *U.S.*, 761 F.2d 688, 691 (Fed. Cir. 1985) (in taxpayer's suit involving tax Article of Panama Canal treaty between U.S. and Panama, Court gave weight to Panamian interpretation of Article and found taxpayer not exempt from U.S. taxes on income earned while employee of Panama Canal Commission).
23. See e.g. *Canada–Israel Development Ltd.* v. *Minister of National Revenue*, [1985] C.T.C. 2460 (in case involving Canada's tax sharing con-

Institutional tension between the Senate and the Executive also affects the way these bodies view international dispute resolution mechanisms. The Senate tends to resist treaty provisions which it believes infringe on its oversight authority, limit its role in the treaty making process or impinge on the obligation of the Congress to write U.S. tax laws. For example, in its report accompanying the United States–Argentina income tax convention,[24] the Senate Foreign Relations Committee (Committee) indicated its concern over a treaty provision authorizing the competent authorities to consult for the elimination of double taxation in cases not provided for by the treaty. The report states that the provision is not intended to authorize the competent authorities to deal with problems of major policy significance that normally would be the subject of treaty negotiations.[25] Similarly, the Committee added a reservation to the United States–France income tax convention[26] relating to exchange of information. A provision of that treaty states that if any changes are made in the tax laws of either the United States or France, and it seems advisable to make adjustments in the provisions of the treaty, such changes may be agreed upon in an exchange of notes. The Committee disagreed and insisted that any treaty changes be subject to the Senate's advice and consent.[27]

Arguably, the Senate may view compulsory dispute resolution provisions which grant decision-making authority in tax matters to third-party entities such as an international court or an arbitral panel with some suspicion because such provisions take authority away from United States revenue authorities and United States courts and give it to bodies over which the Congress has no oversight or control. Indeed, some Senators have expressed these concerns about the standard mutual agreement procedures in existing treaties.[28]

The Executive branch of the U.S. Government may be less resistant to compulsory dispute resolution in the international tax context. In a series of bilateral investment treaties (BITs) signed since October 1982, the United States Trade Representative has approved non-discrimination tax clauses requiring the submission of tax disputes arising under such treaties to arbitration. The tax provisions of the BITs, however, are extremely narrow in scope.

The standard BIT dispute resolution article provides for reference of disputes arising under the BIT to an arbitral panel.[29] The BIT between the United States and Panama provides that the agreement provision on dispute resolution is applicable to tax disputes arising under that agreement.[30] The United States and Panama have no double taxation convention. BITs with countries which have double taxation conventions with the United States provide that tax disputes arising under the BIT which are also subject to the provisions of the double taxation convention will be governed first by the mutual agreement procedures therein. The arbitration provisions of the BIT will only apply if the dispute cannot be resolved through the mutual agreement procedures or if it is not resolved in a reasonable amount of time.[31] The BITs were read into the Con-

vention with Israel, Court makes no reference to any consultation between Canada and Israel or to Israeli interpretation of convention); but see *Hunter Douglas, Ltd.* v. *The Queen*, [1979] C.T.C. 424, 79 D.T.C. 5340 [discontinued] (in case involving tax convention between Canada and The Netherlands, Court hears testimony of Netherlands and United States tax law experts on their countries' interpretations of relevant convention provisions).

24. S. Treaty Doc. No. 10, 97th Cong., 1st Sess. (1981).

25. The United States–Argentina Income Tax Treaty was signed on 7 May 1981. The Senate Foreign Relations Committee reported the treaty out favorably with two reservations and an understanding on 15 December 1981. The treaty has not been ratified and is not in force. The Committee Report gives the following example of the limitations on the consultation provision.

> [T]his provision would not authorize the competent authority to agree to allow a United States foreign tax credit for a tax imposed by the other country where that tax is not otherwise a covered tax or an identical or substantially similar tax imposed after the date of the signature of the treaty.

S. Exec. Rep. No. 44, 97th Cong., 1st Sess. (1981).

26. Convention with respect to Taxes on Income and Property, 28 July 1967, United States–France, 19 U.S.T. 5280, T.I.A.S. 6518.

27. The Senate Foreign Relations Committee Report states the following:

> Article 30(3), relating to an exchange of information, states that if any changes are made in the tax laws of either France or the United States and it seems advisable to make adjustments in the provisions of the convention, such adjustments may be agreed upon through an exchange of notes or in accordance with the constitutional procedure of the respective countries.
>
> In the Committee's view, neither an extension of the provisions of the pending convention to the overseas territories of France nor the adjustment of certain provisions of the convention to changes in the tax laws of this country should be done without the advice and consent of the Senate. Accordingly, the Committee recommends that the convention with France be approved with the following reservation:
>
> The extension of this convention to the Overseas Territories of the French Republic, referred to in Art. 29(1), and the adjustments in the provisions of this convention, referred to in Article 30(3), shall become effective for the United States only in accordance with the procedures set forth in Article II, Section 2, of the Constitution of the United States.

S. Exec. Rep. No. 5, 90th Cong., 1st Sess. (1968).

28. In a 1981 letter to then-Senator Percy, Chairman of the Senate Foreign Relations Committee, Senator Dole, then-Chairman of the Senate Finance Committee, said the following:

> Consistent with preserving the Senate's right to advise and consent regarding tax treaty measures, your committee may wish to develop specific standards to circumscribe the power delegated to the IRS under several treaties [in the mutual agreement provisions] to expand taxing jurisdiction by adjusting amount expressed in currency and by resolving disputes outside of the scope of the treaty.

Abrutyn & Halphen, 402-2d T.M., *Income Tax Treaties – Administrative and Competent Authority Aspects* at A-8 note 5.

29. The Article VII of the Investment Treaty with Panama, S. Treaty Doc. No. 14, 99th Cong., 2d Sess. (1986) (Panama Treaty) governs dispute resolution. It provides for consultation, negotiation and non-binding, third-party procedures. If the dispute is not resolved, the parties may then proceed to conciliation or binding arbitration. Other BITs contain very similar dispute resolution provisions.

30. The Panama Treaty was signed at Washington, D.C. on 27 October 1982. It is currently pending before the United States Senate. The taxation clause of the treaty provides as follows:

> Article XI
>
> 1. With respect to its tax policies, each Party should strive to accord fairness and equity in the treatment of investment of nationals and companies of the other Party.
>
> 2. Nevertheless, this Treaty shall apply to matters of taxation only with respect to the following:
>
> (a) expropriation, pursuant to Article IV;
>
> (b) transfers, pursuant to Article VI; or
>
> (c) the observance and enforcement of terms of an investment agreement or authorization, as referred to in Article VII(1)(a) of (b).

31. See e.g. Investment Treaty with Haiti, S. Treaty Doc. No. 16, 99th

gressional Record and referred to the Senate Foreign Relations Committee in March 1986. Accordingly, the Senate soon will have the opportunity to consider for the first time the advisability of arbitration of bilateral tax disputes.

VI. EVALUATION AND PROGNOSIS

From the taxpayer's and tax practitioner's point of view, the inclusion of compulsory dispute provisions in tax treaties is attractive. Use of such provisions would greatly reduce uncertainty and could actually result in the elimination of double taxation, as opposed to current procedures which provide no assurance thereof. Taxpayers would likely welcome the opportunity provided in the Treaty to participate more directly in competent authority proceedings. Issues of utmost importance, however, are the kinds of dispute resolution tribunals which will be available, the types of cases they will hear and the rules which will govern their deliberations.

Article 44 provides the Contracting Parties with the option of either International Court of Justice (ICJ) adjudication or, if both parties agree, arbitration. As currently drafted, the Article does not provide for an alternative mechanism to choose arbitrators in the event the parties cannot agree on particular individuals. It is also not clear whether the taxpayer will have any role to play in either an ICJ or an arbitration proceeding. Since the ICJ deals only with disputes between member states of the United Nations, the Court will not permit the taxpayer to participate. Arbitration is a more flexible process which might be able to accommodate some type of taxpayer participation if the Contracting States are amenable.

Another difference between the two forums is the expertise of the decisionmakers. The judges of the ICJ are not tax experts; their expertise lies in the interpretation of treaties and general principles of international law. Arbitrators, on the other hand, are selected by the Contracting States. Presumably, the States will be able to select arbitrators who are familiar with particular tax concepts. The desirability of a particular forum may depend in part upon the type of case in issue. ICJ adjudication may be appropriate for disputes regarding significant treaty interpretation issues rather than a case of a particular taxpayer. On the other hand, arbitration may be more appropriate for disputes which are primarily factual such as transfer pricing cases. In such cases, the parties could select arbitrators who have the requisite specialized knowledge.

Another issue posed by the new procedures is whether the decisions of either the ICJ or an Arbitration Court will have any precedential value and whether such decisions will be published. One commentator suggests that the publishing of agreements reached by the competent authorities would provide taxpayers and their counsel with necessary guidance. The United States often publishes agreements reached between its competent authority and the competent authority of a treaty partner.[32] ICJ and arbitration decisions interpreting particular treaty provisions should be published and accorded precedential value, particularly in light of the widespread use of model provisions in bilateral tax treaties. The need for the publication of fact-specific cases involving particular taxpayers is less clear because such cases provide minimal guidance to other taxpayers. Some procedure, similar to Internal Revenue Service publication of private letter rulings in the United States, might be appropriate.

Other issues which Article 44 leaves unresolved include the relationship between the arbitration remedy and any domestic law remedies available to the taxpayer, the allocation of the costs of the arbitration proceeding, and whether or not the information provided to the arbitrators will remain confidential. The existence of these issues does not mean the arbitration process is unworkable, but indicates instead that its implementation will require further thought and planning.

VII. CONCLUSIONS

Article 44 of the Treaty is a welcome experiment. While the possibility of arbitrating tax treaty issues has often been discussed in the OECD and in bilateral negotiations, inclusion in a proposed convention places the idea of arbitrating international tax disputes squarely before the international tax community for further serious discussion. Actual use of the Article 44 procedures by Germany and Sweden will provide data for that discussion.

Cong., 2d Sess. 10 (1986); Investment Treaty with Senegal, S. Treaty Doc. No. 15, 99th Cong. 2d Sess. 11 (1986). The taxation Articles in these two treaties are identical and provide as follows:

Article XI

Taxation

1. With respect to its tax policies, each Party should strive to accord fairness and equity in the treatment of investment of nationals and companies of the other Party.

2. Nevertheless, the provisions of this Treaty, and in particular Articles VII and VIII, shall apply to matters of taxation only with respect to the following:

(a) expropriation, pursuant to Article III:

(b) transfers, pursuant to Article V; or

(c) the observance and enforcement of terms of an investment agreement or authorization as referred to in Article VII(1)(a) or (b).

Matters covered by item 2(c) shall not be covered to the extent they are subject to the dispute settlement provisions of a convention for the avoidance of double taxation between the two Parties, unless such matters are raised under such settlement provisions and are not resolved within a reasonable period of time.

32. See e.g. Rev. Rul. 67-143, 1967-1 C.B. 425 (definition of "subsidiary" corporation under U.S.-Swiss treaty); Rev. Rul. 77-269, 19772 C.B. 490 (definition of commercial profits under U.S.-U.K. treaty). The most far-reaching, complicated, and novel of such agreements is probably the agreement reached with respect to taxation of U.S. oil rigs operating in offshore Canadian waters. U.S. Treasury Department Press Release, 17 February 1984, containing agreement between U.S. and Canadian competent authorities of 26 January 1984 (Reproduced in Par. 1317PA, (CCH) Tax Treaties Service).

APPENDIX I

Article 25 of the 1977 OECD Model provides as follows:

1. Where a person considers that the actions of one or both of the Contracting States result or will result for him in taxation not in accordance with the provisions of this Convention, he may, irrespective of the remedies provided by the domestic law of those States, present his case to the competent authority of the Contracting State of which he is a resident or, if his case comes under paragraph 1 of Article 24, to that of the Contracting State of which he is a national. The case must be presented within three years from the first notification of the action resulting in taxation not in accordance with the provisions of the Convention.

2. The competent authority shall endeavour, if the objection appears to it to be justified and if it is not itself able to arrive at a satisfactory solution, to resolve the case by mutual agreement with the competent authority of the other Contracting State, with a view to the avoidance of taxation which is not in accordance with the Convention. Any agreement reached shall be implemented notwithstanding any time limits in the domestic law of the Contracting States.

3. The competent authorities of the Contracting States shall endeavour to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the Convention. They may also consult together for the elimination of double taxation in cases not provided for in the Convention.

4. The competent authorities of the Contracting States may communicate with each other directly for the purpose of reaching an agreement in the sense of the preceding paragraphs. When it seems advisable in order to reach agreement to have an oral exchange of opinions, such exchange may take place through a Commission consisting of representatives of the competent authorities of the Contracting States.

M. Edwards-Ker, *The International Treaties Service* (1977) at art. 25, p.1.

APPENDIX II

Article 25 of the 1977 U.S. Model provides as follows:

1. Where a person considers that the actions of one or both of the Contracting States result or will result for him or her in taxation not in accordance with the provisions of this Convention, he or she may, irrespective of the remedies provided by the domestic law of those States, present his or her case to the competent authority of the Contracting State of which he or she is a resident or national.

2. The competent authority shall endeavor, if the objection appears to it to be justified and if it is not itself able to arrive at a satisfactory solution, to resolve the case by mutual agreement with the competent authority of the other Contracting State, with a view to the avoidance of taxation which is not in accordance with the Convention. Any agreement reached shall be implemented notwithstanding any time limits in the domestic law of the Contracting States.

3. The competent authorities of the Contracting States shall endeavor to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the Convention. In particular the competent authorities of the Contracting States may agree:

(a) to the same attribution of income, deductions, credits, or allowances of an enterprise of a Contracting State to its permanent establishment situated in the other Contracting State;
(b) to the same allocation of income, deductions, credits, or allowances between persons, including a uniform position on the application of the requirements of paragraph 3 of Article 24 (Non-discrimination);
(c) to the same characterization of particular items of income;
(d) to the same application of source rules with respect to particular items of income; and
(e) to a common meaning of a term.
They may also consult together for the elimination of double taxation in cases not provided for in the Convention.

4. The competent authorities of the Contracting States may communicate with each other directly for the purpose of reaching an agreement in the sense of the preceding paragraphs.

5. The competent authorities of the Contracting States may prescribe regulation to carry out the purposes of this Convention.

Article 25 of the 1981 U.S. Model is quite similar and provides as follows:

1. Where a person considers that the actions of one or both of the Contracting States result or will result for him in taxation not in accordance with the provisions of this Convention, he may, irrespective of the remedies provided by the domestic law of those States, present his case to the competent authority of the Contracting State of which he is a resident or national.

2. The competent authority shall endeavor, if the objection appears to it to be justified and if it is not itself able to arrive at a satisfactory solution, to resolve the case by mutual agreement with the competent authority of the other Contracting State, with a view to the avoidance of taxation which is not in accordance with the Convention. Any agreement reached shall be implemented notwithstanding any time limits or other procedural limitations in the domestic law of the Contracting States.

3. The competent authorities of the Contracting States shall endeavor to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the Convention. In particular the competent authorities of the Contracting States may agree

(a) to the same attribution of income, deductions, credits, or allowances of an enterprise of a Contracting State to its permanent establishment situated in the other Contracting State;
(b) to the same allocation of income, deductions, credits, or allowances between persons;
(c) to the same characterization of particular items of income;
(d) to the same application of source rules with respect to particular items of income;
(e) to a common meaning of a term;
(f) to increases in any specific amounts referred to in the Convention to reflect economic or monetary developments; and
(g) to the application of the provisions of domestic law regarding penalties, fines and interest in a manner consistent with the purposes of the Convention.

They may also consult together for the elimination of double taxation in cases not provided for in the Convention.

4. The competent authorities of the Contracting States may communicate with each other directly for the purpose of reaching an agreement in the sense of the preceding paragraphs.

APPENDIX III

Article 25 of the United Nations Model Double Taxation Convention Between Developed and Developing Countries provides as follows:

1. Where a person considers that the actions of one or both of the Contracting States result or will result for him in taxation not in accordance with the provisions of this Convention, he may, irrespective of the remedies provided by the domestic law of those States, present his case to the competent authority of the Contracting State of which he is a resident or, if his case comes under paragraph 1 of article 24, to that of the Contracting State of which he is a national. The case must be presented within three years from the first notification of the action resulting in taxation not in accordance with the provisions of the Convention.

2. The competent authority shall endeavor, if the objection appears to it to be justified and if it is not itself able to arrive at a satisfactory solution, to resolve the case by mutual agreement with the competent authority of the other Contracting State, with a view to the avoidance of taxation which is not in accordance with this Convention. Any agreement reached shall be implemented notwithstanding any time-limits in the domestic law of the Contracting States.

3. The competent authorities of the Contracting States shall endeavor to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the Convention. They may also consult together for the elimination of double taxation in cases not provided for in the Convention.

4. The competent authorities of the Contracting States may communicate with each other directly for the purpose of reaching an agreement in the sense of the preceding paragraphs. The competent authorities, through consultations, shall develop appropriate bilateral procedures, conditions, methods and techniques for the implementation of the mutual agreement procedure provided for in this article. In addition, a competent authority may devise appropriate unilateral procedures, conditions, methods and techniques to facilitate the above-mentioned bilateral actions and the implementation of the mutual agreement procedure.

U.N. Doc. No. ST/ESA/102/1980.

International Financings by U.S. Borrowers: Questions Remain Open after Repeal

By James A. Duncan

Two years after the repeal of U.S. withholding tax on "portfolio interest", a number of important questions concerning the scope of the repeal remain unanswered. Some of the uncertainties are attributable to fundamental assumptions made by the United States Treasury Department in drafting regulations to implement the repeal. The purpose of this article is not, however, to advocate a rethinking of the basic premises of the regulations (since much eloquence has already been expended on this subject by other commentators). Instead, this article generally takes the regulations on their own terms, and seeks to apply them in the context of actual transactions.

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It is important to note at the outset that repeal has greatly simplified the process of obtaining access to the Euromarket for most U.S. borrowers. While the offshore finance subsidiary structures in use prior to repeal were cost-effective for many U.S. corporations, the structures were cumbersome and carried with them unavoidable uncertainties. For many U.S. borrowers, repeal has opened the door to previously inaccessible capital markets. Tax uncertainties and transaction costs deterred some U.S. corporations from using finance subsidiaries to raise funds in the Euromarket; political considerations generally made it impossible for public sector borrowers (most notably, the United States Treasury Department) to borrow through finance subsidiaries.

Regulations implementing the repeal, while unsatisfactory for some purposes, nevertheless make it possible to issue conventional debt instruments to foreign investors on a withholding tax-free basis. The continued existence of significant pockets of uncertainty two years after repeal may be attributed in varying degrees to the following causes:

(1) The pace of innovation in the international capital markets. The diversity and sophistication of new financial products would make it difficult for even the most flexible regulatory system to prescribe answers to all questions.

(2) The demands placed on the Treasury Department by new tax legislation and tax reform proposals. As indicated above, conventional Eurobond issues generally are not affected by the gaps and anomalies in the regulations implementing withholding tax repeal. Accordingly, it is easy to understand why the Treasury Department might choose to focus its energies in other areas.

(3) Ambivalence concerning the appropriate scope of withholding tax repeal. Tax policymakers apparently also continue to disagree concerning the extent to which the Euromarket's preference for instruments in bearer form can be reconciled with the objective of requiring U.S. taxpayers to report and pay taxes on their investment income. In the absence of a consensus, projects to remedy even the most visible defects in the existing regulations proceed fitfully.

BACKGROUND

Until 1984, interest paid by U.S. borrowers to foreign lenders generally was subject to a 30% U.S. withholding tax, unless (i) the payments represented "discount" (including for this purpose a single payment of interest at maturity) on specified short-term obligations or (ii) the lender qualified for an exemption (by reason, for example, of its entitlement to U.S. tax treaty benefits or status as a foreign government). The Tax Reform Act of 1984 provided a third exemption for "portfolio interest" on debt obligations issued after 18 July 1984.

The Act's definition of "portfolio interest" might be read to include *all* interest on obligations issued after the relevant date (subject to compliance with technical requirements), with exceptions for interest paid on bank loans and loans from related parties. However, regulations issued on 20 August 1984 provided that the term includes only interest on "registration-required obligations", a category that excludes (i) obligations with an original maturity of one year or less, (ii) obligations that are not of a type offered to the public; and (iii) obligations issued by natural persons. As will be discussed in more detail below, many of the gaps and anomalies in the regulatory scheme arise directly from the adoption of these exclusions, which were originally designed for another statutory purpose and fit imperfectly here.

Even before the repeal of U.S. withholding tax on "portfolio interest", only a comparatively small portion of the total volume of interest payments to foreign lenders was subject to U.S. withholding tax: the extensive U.S. tax treaty network frequently made it possible for institutional lenders to make loans directly, while investors ineligible for treaty benefits (or unwilling to identify themselves to claim the benefits) could buy Eurobonds issued by finance subsidiaries of U.S. companies. Accordingly, while the purpose of the U.S. withholding tax was (and is) to collect tax from foreigners receiving income from U.S. sources, transactions subject to the tax recently have been the exception rather than the rule.

In light of the limited revenue derived from the tax even before the repeal, when withholding applied, in theory, to a broad class of interest payments, arguments for defining "portfolio interest" narrowly have had to rely on subtleties reminiscent of those encountered in debates over new weapons systems. Thus, when the Treasury Department last year asked Congress to enact legislation narrowing the exemption, its spokesman argued that preserving a generally applicable withholding tax on some interest payments would enable the Treasury to bargain for reciprocal exemptions of all payments in bilateral tax treaty negotiations.

In addition to the U.S. withholding tax on interest, borrowers seeking to design instruments that can be sold in the Euromarket have to contend with U.S. tax compliance rules whose purpose is to collect taxes from U.S. residents. These rules, which are not discussed in detail in this article, include: (i) information reporting requirements, under which borrowers and financial intermediaries must file reports with the Internal Revenue Service concerning certain payments of investment income to U.S. residents; (ii) a "backup" withholding tax, which is required to be collected from payments subject to information reporting when the payee fails to furnish the required information; and (iii) registration requirements, under which debt obligations sold in the United States generally must be in registered form and obligations sold outside the United States may be issued in bearer form only pursuant to procedures designed to limit distribution to non-U.S. investors. The rules generally provide exemptions from information reporting and backup withholding for payments to foreign investors and for certain Euromarket transactions.

These tax compliance rules are relevant in structuring issues of securities for sale in the Euromarket because of the market's perceived strong preference for instruments in bearer form and aversion to identification and certification requirements. The principal tax question is whether, in the context of a particular transaction, the rules will permit an issuer to satisfy this market preference. As with the withholding tax rules that are the subject of this article, regulations implementing the tax compliance requirements provide adequate guidance for conventional Eurobonds, but are flawed in other significant respects.

The remainder of this article lists questions that can arise in considering whether a withholding tax exemption is available for (i) securities not sold in a public offering; (ii) certificates representing interests in a pool of financial assets; and (iii) short-term debt obligations. The questions discussed are ones that can arise in the real world, in transactions whose structure is dictated by business considerations – a borrower's desire to raise money on favorable terms, a banker's desire to add value by pooling or repackaging securities – rather than by any tax objective. In the absence of clear guidance from the Treasury Department, many tax practitioners have been able to conclude that instruments with the characteristics discussed below should qualify for the benefits of withholding tax repeal. The absence of definitive rules, however, may in some cases hinder transactions that violate no discernible tax policy.

SECURITIES NOT SOLD IN A PUBLIC OFFERING

As indicated above, the regulations provide that a debt instrument will qualify for the benefits of repeal only if it sufficiently resembles (is "of a type" with) other debt instruments that have been offered to the public. Examples in the regulations, and positions taken by the Internal Revenue Service in private letter rulings, offer little guidance as to the characteristics that are relevant in determining whether one instrument is of a type with another.

It seems indisputable that debt instruments that are *in fact* offered to the public, no matter how novel, are "of a type offered to the public". Under this standard, it is unnecessary to consider whether a new issue of dual currency obligations or "inverse yield" notes (to cite two comparatively recent innovations) has any comparable predecessors if the issue constitutes a public offering in its own right. There can, of course, be questions at the margin as to whether a particular security was in fact offered to the public. For instance, are obligations offered to the public if they are sold in Europe pursuant to procedures that, if followed domestically, would constitute a public offering for U.S. securities law purposes? Should the absence of sales restrictions be the controlling factor, or are other characteristics commonly associated with publicly-offered securities (e.g. listing on a securities exchange, or the maintenance of an active secondary market) also relevant? Does it matter whether the offering is considered public or private in the market in which it is made?

It is equally clear that a debt instrument that is identical to publicly-traded Eurobonds is "of a type" with them, no matter how unusual the circumstances of its issuance. There would appear to be no basis under existing law for denying the benefits of repeal to debt instruments representing seller financing for the sale of capital goods to a U.S. purchaser, so long as the instruments resemble in every material respect other securities (whether or not of the same borrower) that were in fact offered to the public.[1] Thus, it may be possible in some cases to achieve substantial comfort that a withholding tax exemption will be available for privately-placed securities by slavishly following model documentation used in a public offering.

In many cases, however, some differences will be unavoidable. In the absence of a clear policy rationale for limiting the benefits of withholding tax repeal to obligations that resemble publicly-offered obligations, it is very difficult to determine what sorts of differences should be taken into account. As a starting point, it seems clear that characteristics of a privately-placed debt security that are required because the instrument was not *in fact* offered to the public – for example, restrictions on transferability and high minimum denominations required to assure the availability of a private placement exemption for securities law purposes – are not relevant in determining whether the security is of a type offered to the public. Any other conclusion would render the "of a type" standard meaningless.

Additional questions can arise when differences in the terms of a debt security are not attributable solely to the absence of a public distribution. Some differences may be essentially formal rather than substantive. For example, equipment trust certificates and notes issued in "sale-saleback" arrangements confer essentially identical economic rights on lenders: the choice of one structure for a secured financing transaction over the other depends on non-tax considerations. If equipment trust certificates are commonly offered to the public, and "sale-saleback" notes are not, should they be treated differently for withholding tax purposes?

Whether differences relate to matters of form or substance, the important question will always be whether they are material in applying the "of a type" standard. For example, should a note issued to a Belgian insurance company in a private placement be considered "of a type offered to the public" if the insurance company exacts financial covenants from the borrower commonly found in private placements, but rarely seen in public debt instruments? If each of the material terms of the note is commonly found in public debt instruments, but no single instrument contains precisely the same combination of terms as the note, should the note be eligible for the benefits of withholding repeal? If the form of note resembles a conventional Eurobond, does it matter that the loan agreement to which the note appertains is materially different from the underwriting and fiscal agency agreements used for Eurobonds? Should it matter whether the notes are steel-engraved?

None of these questions (except possibly the last) is frivolous: the "of a type" standard by its very nature suggests that general similarity, rather than precise correspondence, is what makes one note of a type with another. Tax practitioners may have different views as to the characteristics, or combination of characteristics, that should be taken into account for this purpose. In the end, the judgment is as much financial as legal: issuers considering the private sale of financial instruments with unusual terms in some cases have asked their financial advisers whether comparable instruments can be found in the public capital markets.

PASS-THROUGH CERTIFICATES

The August 1984 regulations had the effect of denying the benefits of withholding tax repeal to mortgage pass-through securities, which are treated for other U.S. tax purposes as direct ownership interests in the pool of mortgages underlying the securities. (The mortgages typically are issued by natural persons and hence are not "registration-required obligations".) In the face of criticism that began almost immediately upon the publication of the regulations, the Treasury eventually modified its position. Regulations issued on 20 August 1985 provide that certificates representing ownership interests in a pool of obligations issued after 18 July 1984 can qualify for the "portfolio interest" exemption even if direct interests in any of the obligations making up the pool would not qualify.

The regulations are not limited to certificates representing interests in pools of mortgages, and instead provide expressly that a "similar evidence of interest in a similar pooled fund or trust" can qualify for exemption. Certificates representing interests in a

1. The Treasury Department sought legislation in May of 1985 to deny the benefits of withholding tax repeal to privately-placed securities and trade indebtedness. That proposal was not incorporated in the legislation then under consideration, and has not resurfaced as part of recent tax reform proposals.

pool of consumer receivables (such as the recent issues in the U.S. capital market of certificates representing interests in a pool of automobile loans) would appear to qualify for the "portfolio interest" exemption under this rule.

There is little formal guidance concerning the reasons why the Treasury determined that interest on an obligation not qualifying for tax exemption can become tax-exempt if the obligation is pooled with other similar obligations, and what types of pooling transactions suffice to effect this transmutation. The regulations give the Internal Revenue Service authority to disqualify certificates by recharacterizing them "in accordance with the substance of the arrangement they represent." The example provided in the regulations of a transaction in which this authority might be exercised involves a repackaging of a single issue of securities of a single U.S. corporation. Informal conversations with Treasury officials suggest that they consider diversification to be the critical factor in determining whether certificates representing interests in a pool of obligations will be considered "registration-required obligations" that yield "portfolio interest."

Under this approach, it would appear that certificates representing interests in a pool of non-qualifying securities should generate "portfolio interest" if the pooling significantly changes the credit quality or liquidity of the underlying assets. Qualification thus would not necessarily depend on the number of securities included in the pool, but on whether the pooling creates a meaningfully different investment security.

SHORT-TERM OBLIGATIONS

The oddest anomaly created by the "portfolio interest" regulations is perhaps the one that merits the least discussion. The regulations deny the benefits of withholding tax repeal to obligations with a maturity of one year or less; a separate, longstanding exemption is available for obligations with a maturity of up to 183 days. The result is a "black hole" in which no tax exemption is available for obligations with an initial maturity of more than 183 and less than 366 days (367 in leap years). While obligations with maturities in this range unquestionably can be found in the U.S. capital markets, the denial of a withholding tax exemption for such obligations does not seem to have given rise to a widespread outcry. The principal practical consequence of this anomaly for Euromarket transactions (where issuers commonly bear withholding tax risks under "gross-up" provisions) is that the documentation of note facility agreements and issues of warrants to buy debt instruments must occasionally be adjusted to ensure that the issuer will never be obligated to issue obligations during the "black hole" period (e.g. between 366 and 183 days before the maturity of notes issuable upon the exercise of warrants).

The past few years have seen a proliferation of transactions in which U.S. borrowers sell short-term debt in the Euromarket on a continuous basis in reliance on the withholding tax exemption for short-term discount obligations. The "portfolio interest" exemption can also be relevant to such obligations, notwithstanding their short maturity, in the circumstances described below.

The transactions can involve the issuance of notes at the discretion of the issuer for sale to purchasers who are under no obligation to buy them (in which event no withholding tax issue will arise, and the principal structuring questions relate to the U.S. tax compliance rules). Alternatively, the issuer may have entered into agreements under which some institutions are obligated to purchase its notes initially; or must purchase any notes that cannot be sold in the market; or must lend the issuer money (on terms and with documentation that differ from the terms and documentation of the notes) if the issuer is unable to sell notes.

The Internal Revenue Service has taken the position that, if a borrower has the right to require the holder of its short-term note to buy a new note when the old one matures, the original short-term note should be considered to have a maturity equal to the maximum amount of time for which the borrower has this rollover right. The position taken by the Service seems reasonable, in the abstract, although there is much room for discussion as to when it should be applied in the context of a particular transaction.

Assume, however, that a corporate borrower enters into an agreement with underwriters (some of whom are also banks) providing for the issuance of notes with a maturity of precisely 183 days. The agreement provides that the underwriters will use their best efforts to sell new issues of notes to the public, and, if no purchasers can be found, will buy the notes themselves. Under this arrangement, notes actually sold to the public will have a maturity of 183 days or less and therefore will be exempt from withholding; notes purchased by the underwriters pursuant to their commitment to do so will, under the Service's analysis, have a maturity of at least 366 days (since the underwriters would be obligated to buy new notes at the maturity of old notes if the notes could not be sold to the public).

Should payments on the notes held by the underwriters qualify for the "portfolio interest" exemption? The notes unquestionably will meet the requirements introduced by the regulations: they will be of a type offered to the public, will have a maturity of more than one year, and will not be obligations of natural persons. If the notes are issuable in bearer form, the issuer can satisfy the procedural requirements applicable to bearer-form obligations. The only question is whether the statutory exclusion of interest on certain bank loans – more precisely, interest "received by a bank on an extension of credit made pursuant to a loan agreement entered into in the ordinary course of its trade or business" – should operate to disallow a withholding tax exemption.

In this regard, it is clear that an ordinary underwritten debt facility (e.g. a conventional Eurobond) will not constitute a bank loan, without regard to whether some of the underwriters or investors are banks. A short-term note facility may be more vulnerable to characterization as a bank loan because (i) the transaction may function as a substitute for or successor to traditional bank lending transactions, and (ii) underwriters (who may be banks) are required in some circumstances to buy notes over a period of time, unlike traditional underwritings, where the terms of each new issue of securities are separately negotiated. On the other hand, the notes are designed for sale to the public and often will be sold to the public. The regulations provide no guidance as to whether and in what circumstances notes purchased by banks pursuant to a backup commitment might be characterized as bank loans. In any event, since the exclusion for bank loans applies only to interest *received by* a bank on an extension of credit in the ordinary course of *its* trade or business, it would appear that notes acquired by banks and resold to the public (including other banks) would cease to be bank loans and thus would be eligible for the benefits of withholding repeal.

INTERNATIONAL FISCAL ASSOCIATION NEWS

INDIA BRANCH

Second Annual Meeting

On 17 May 1986 the India Branch of IFA held its second Annual General Meeting in New Delhi. The meeting was chaired by Mr. O.P. Vaish and was attended by 16 members, 3 of which by proxy. The Chairman, inter alia, informed the members that the Indian exchange authorities have agreed to release foreign exchange for 15 delegates to participate in the 1986 IFA Congress to be held in New York.* The members proposed that a national IFA meeting should be held in August 1986 in Calcutta. During this meeting the subjects for the 1987 Brussels Congress could be discussed.

Double taxation treaties

During the meeting the subject of double taxation treaties was discussed and note was taken of the treaties which are currently under negotiation. It was stated that the Government of India – unlike governments of some treaty partners – has been treating tax treaties, until they are officially notified, as secret. This can cause embarrassment as parties in such treaty countries often obtain copies of draft treaties as soon as they have been negotiated. The members present felt that there was no point in considering treaty documents as secret or confidential when the other treaty party does not follow the same policy. It was decided that a suitable representation would be made to the Central Board of Direct Taxes to this effect.

Successful conference

The meeting also discussed the *Annual Report for the Calendar Year 1985*. Despite its brief existence, modest personnel, and limited financial resources the Indian IFA Branch ventured into convening an *All India Tax Conference: Towards easier tax regime and tough implementation* to discuss the policy of tax reforms and liberalisation initiated by the Government of India. The conference provided an excellent opportunity for interaction between delegates on issues relating to the formulation of the long-term fiscal policy and the thoughts of the current administration on the subject. The Conference was timed to coincide with the visit of IFA's Secretary General, Prof. Dr. J.H. Christiaanse and the Chairman of its Permanent Scientific Committee, Dr. Raoul Lenz, so that the benefit of their expertise based on international experience was available to the delegates. A full session was devoted to the discussion of issues relating to tax treaties with special reference to India's recent treaties with the United Kingdom and the Federal Republic of Germany, and the existing treaty with Japan.

[continued on page 368]

* Currently the Reserve Bank of India allows foreign exchange for a maximum number of 15 persons to attend a foreign congress.

Caveat Vendor:

Withholding Requirements for Transfers of United States Real Property Interests

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As a result of the Deficit Reduction Act of 1984, a transferee is now generally required to deduct and withhold a tax equal to 10% of the amount realized on all dispositions of U.S. real property interests (USRPIs) taking place after 31 December 1984.[1]

A 10% withholding rate was selected because the U.S. House and Senate conferees agreed that in most cases a 10% rate would approximate the amount of net tax owed by most foreign transferors on the disposition of a USRPI. No withholding applies to payments in respect of dispositions taking place prior to 1 January 1985.

No later than 10 days after the transfer, the transferee is required to file Forms 8288 and 8288-A with the Internal Revenue Service (the IRS) in Philadelphia. The IRS will stamp and mail Form 8288-A to the transferor.[2] An agent may, under certain circumstances,[3] succeed to the withholding obligation of the transferee, but only to the extent of the agent's compensation derived from the transaction.[4]

DEFINITIONS

The following defined terms are helpful in understanding the withholding statute:

Amount realized – the sum of cash paid or to be paid; the fair market value of other property transferred or to be transferred; and the outstanding amount of any liability assumed by the transferee to which a USRPI is subject immediately before and after the transfer.[5]

Transferor – the person disposing of a USRPI.[6]

Transferee – the person acquiring the USRPI.[7]

Transferor's agent – any person who represents the transferor in any negotiation with the transferee or the transferee's agent; or in settling the transaction.[8]

Transferee's agent – any person who represents the transferee in any negotiation with the transferee or the transferee's agent; or in settling the transaction.[9]

Settlement officer – one who merely receives or disburses consideration and/or records a document; and who will, therefore, not be considered an agent.[10]

1. Section 1445(a). All section and regulation references herein are to the U.S. Internal Revenue Code of 1954, as amended, and to the regulations thereunder, unless otherwise specified.
2. Temp. Reg. § 1.1445-1(c).
3. See text accompanying fns. 27-31, below.
4. Section 1445(d)(2).
5. Temp. Reg. § 1.1445-1T(g)(5).
6. Section 1445(f)(1).
7. Section 1445(f)(2).
8. Section 1445(d)(3).
9. Section 1445(d)(4).
10. Section 1445(d)(5).

Transferor's maximum liability – the sum of the maximum amount of tax on the disposition of the USRPI imposed at graduated rates under sections 871(b)(1) or 882(a)(1) depending upon whether the transferor is an individual or a corporation. In the case of an individual transferor , the transferor's maximum liability is the contract price less the adjusted basis. In the case of a corporate transferor, the transferor's maximum liability is the contract price less the adjusted basis multiplied by the maximum capital gain rate, subject to adjustment for treaty rate reductions, non-recognition provisions, losses on USRPIs previously disposed of, recapture items, and the like. In both cases, the transferor's unsatisfied withholding liability is added to these amounts.[11]

Transferor's unsatisfied withholding liability – the withholding obligation imposed by new section 1445 either on the transferor's acquisition of a USRPI or on the acquisition of a predecessor interest, to the extent the withholding obligation has not been satisfied.[12]

United States real property interest (USRPI) – an interest, other than an interest solely as a creditor, in real property located in the United States or the Virgin Islands; and an interest, other than an interest solely as a creditor, in a domestic corporation which is a United States real property holding corporation.[13]

United States real property holding corporation (USRPHC) – any non-public corporation where, on any determination date during the calendar year, the fair market value of its USRPIs equals or exceeds 50% of the sum of the fair market values of its USRPIs, plus all interests in real property outside the United States and all other assets used or held for use in a trade or business. The applicable determination dates are: 31 December of the calendar year; the date immediately preceding the date on which the corporation disposes of a USRPI; and the date immediately preceding the date on which the corporation acquires an interest in foreign real property or other assets used or held for use in a trade or business during the year.[14]

DISTRIBUTIONS BY USRPHCs TO FOREIGN SHAREHOLDERS

A USRPHC that was such for the shorter of the period after 18 June 1980, or the five-year period ending with the disposition of the interest in the USRPHC, must deduct and withhold a 10% tax on the amount received by a foreign shareholder from: (a) any distribution in respect of either a redemption of all or a part of the stock in the USRPHC; (b) a liquidation, whether complete or partial, of the USRPHC or any subsidiary; or (c) a deemed sale or exchange of the USRPHC stock to the extent that the USRPHC is a collapsible corporation.[15]

Note that with respect to liquidating distributions of non-USRPIs by a domestic corporation which has not made a section 337 election, a qualifying statement[16] may be requested on the ground that the foreign shareholder's surrender of his interest in the corporation may not be subject to tax under the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA). The rationale for this position is that where the corporation has not elected section 337 treatment, tax will have been paid at the corporate level; and section 897(c)(1)(B) excludes from the definition of a USRPI an interest in a corporation not currently holding USRPIs and that was taxed at the corporate level on previous distributions of such interests. Note that the Tax Reform Bill of 1985 (H.R. 3838), which is being considered by the U.S. Senate at this writing, specifically amends section 1445(e)(3) to exempt from withholding a distribution of any interest in a corporation, which interest is not a USRPI by virtue of section 897(c)(1)(B).

Where the Code accords non-recognition treatment to the foreign distributee of a USRPI distributed in liquidation of a domestic corporation, and where this non-recognition treatment is not overridden by section 897(e), a qualifying statement may also be requested to exempt the domestic corporation from withholding.[17]

DISTRIBUTIONS BY FOREIGN CORPORATIONS

A foreign corporation must deduct and withhold a 28% tax on the amount of gain recognized in any distribution which is subject to tax under sections 897(d) and (e).[18]

The conferees intended that even foreign corporations electing under section 897(i) to be treated as a domestic corporation for substantive and reporting provisions, would be treated as foreign persons, for withholding purposes. Since a foreign corporation making a section 897(i) election could elect tax-free treatment of a liquidation-related sale, the conferees intended that a tax withheld on such a sale be offset by a credit, to be implemented by regulations. Moreover, the conferees felt that if the section 897(i) election were applicable to withholding, an electing foreign corporation could provide a non-foreign certification, which would be confusing. However, the temporary regulations which have since been issued specify when such a certification is valid as the result of a section 897(i) election by requiring the transferor to attach a copy of the section 897(i) election acknowledged by the IRS.[19]

Note that H.R. 3838 seeks to resolve this issue by including a provision which would allow corporations making a section 897(i) election to be treated as a domestic corporation for withholding purposes as well.

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11. Section 1445(f)(4), Temp. Reg. § 1.1445-3T(c)(v).
12. Section 1445(f)(5).
13. Section 897(c), Treas. Reg. § 1.897-1(c).
14. Section 897(c)(2), Treas. Reg. § 1.897-2(c).
15. Section 1445(e)(3).
16. See text accompanying fns. 32-41, below.
17. See text accompanying fns. 32-41, below.
18. Section 1445(e)(2).
19. Temp. Reg. § 1.1445-2T(b)(2)(ii), 1.1445-5T(b)(3)(ii)(C), and 1.1445-7T(a).

DISTRIBUTIONS BY PARTNERSHIPS, TRUSTS AND ESTATES TO FOREIGN PARTNERS, FOREIGN BENEFICIARIES AND CERTAIN GRANTORS

A domestic partnership, the trustee of a domestic trust, and the executor of a domestic estate must deduct and withhold a 10% tax on any amount under the custody of any such person, which is attributable to the disposition of a USRPI by the entity and is includible in the income of either a foreign partner of the partnership; a foreign beneficiary of the trust or estate; or a foreign person who is treated as the owner of the trust under section 671.[20]

A domestic or foreign partnership, the trustee of a domestic or foreign trust, and the excecutor of a domestic or foreign estate, any of which distribute a USRPI to a foreign partner or beneficiary in exchange for all or a part of his interest in the entity, as provided by section 897(g), must deduct and withhold a 10% tax on the fair market value of the USRPI at the time of the distribution. Note, however, that since regulations under sections 897(e)(2) and 897(g) have not yet been promulgated to define when a distribution of an interest in an entity may be taxable, withholding on distribution of such interests will be postponed until section 897(g) regulations are effective.[21]

Note also that H.R. 3838 proposes that domestic partnerships, estates and trusts withhold on distributions of USRPIs at the rate of 28% of the gain realized, to the extent that the gain is taken into account by or allocable to a foreign beneficiary or foreign partner, as the case may be. Apparently, it is deemed feasible to withhold on the basis of gain in this circumstance since the transferor's fiduciary will have some notion of the transferor's basis in the distributed interest. However, the 28% rate assumes that all partners and beneficiaries are corporations, which assumption appears unjustified.

Finally, H.R. 3838 seeks to amend section 1445(e)(4) to omit the specific reference to distributions subject to tax pursuant to section 897(g), inasmuch as such distributions may also be subject to tax pursuant to section 897(e)(2)(B) and should, therefore, be subject to withholding as well.

TRANSFEREES OF NON-CORPORATE ENTITY INTERESTS

The transferee of a partnership interest or a beneficial interest in a trust or estate must deduct and withhold a 10% tax on the amount realized on the disposition.[22] Since regulations under sections 897(e)(2) and 897(g) have not yet been promulgated to define when a distribution of an interest in an entity may be taxable, withholding on distribution of such interests will be postponed until section 897(g) regulations are effective.[23]

EXEMPTIONS

A non-foreign certification of the transferor may be furnished by the transferor to the transferee.[24] It must state, under penalty of perjury, that the transferor is not a foreign person; give the transferor's name, taxpayer identification number, and home address (in the case of an individual) or office address. No particular form is prescribed for the certification; and there is no implication that the certification must be sworn out before a notary, an issue which was of great concern to many foreign investors. Non-mandatory sample certification forms which the IRS will accept are set forth at Temp. Reg. § 1.1445-2T(b)(2)(iii)(A) and (B). The transferee must retain the certification until the end of the fifth year following the taxable year in which the transfer takes place. A foreign corporation that has made an election under section 897(i) may furnish this certification if it attaches a copy of the IRS's acknowledgment of the election under Treas. Reg. § 1.897-3(d)(4) subject, however, to the exception from this exemption, discussed below.[25]

A non-foreign certification of a non-public domestic corporation exempts from withholding the transfer of any interest in a non-public domestic corporation. It may be furnished by a corporation to the transferee and states, under penalty of perjury, that the corporation was not a USRPHC for the previous five years. Note that H.R. 3838 would add an alternative certification that interests in the corporation are not USRPIs because the corporation either held as USRPIs or because the USRPIs held by the corporation were disposed of in a transaction in which the full amount of gain was recognized.[26] No particular form is required, and there is no implication that certification must be sworn out before a notary. Acceptable sample certifications are, however, set forth at Temp. Reg. § 1.1445-2T(b)(2)(iii)(A) and (B). The retention requirements and the provisions regarding coordination with the Section 897(i) election applicable to the non-corporate certification, set forth above, apply here as well. Well-advised purchasers of stock in any domestic non-public corporation will seek such a certification and supporting warranties in the purchase agreement.

The foregoing certification exemptions do not apply if the transferee has knowledge that a certification is false, whether such knowledge is either actual or constructive, by virtue of notice of false certification, issued pursuant to section 1445(d)(1), by an agent of either the transferor or transferee.[27] The agent who furnishes this notice, however, must have actual knowledge. In the case of a foreign corporate transferor, its agent will be deemed to have actual knowledge that any non-foreign affidavit is false.

20. Section 1445(e)(1) and (4).
21. Temp. Reg. § 1.1445-5T(b)(8)(v).
22. Section 1445(e)(5).
23. Temp. Reg. § 1.1445-5T(b)(8)(v).
24. Temp. Reg. § 1.1445-2T(b)(2).
25. See text accompanying fns. 27-31, below.
26. Section 897(c)(1)(B).
27. Section 1445(b)(7).

The notice of false certification must be filed with the transferee as soon as possible, if the transfer has not yet occurred. If the transfer has occurred, the agent must file the notice within three days of learning that the certification was false.[28] Although no form of notice of false certification is required, the temporary regulations set forth an acceptable form of notice. Failure to furnish the notice of false certification as specified by the regulations, which includes furnishing a copy of the notice to the IRS,[29] will result in imposition of direct liability for withholding on the agent, but only to the extent of his compensation derived from the transaction.[30]

A transferee is still entitled to rely on a non-foreign certification for payments made prior to delivery of a notice of its falseness. However, the transferee must thereafter withhold 10% of the amount realized, if possible.[31]

A qualifying statement that the Secretary of the Treasury has reached agreement with either the transferor or the transferee that either: (a) the transferor's tax on the gain from disposition of the USRPI, pursuant to section 871(b)(1) or 882(a)(1), will be paid; or (b) the transferor is exempt from such tax. Additionally, the qualifying statement evidences that any unsatisfied withholding tax liability of the transferor has either been satisfied or adequately secured.[32] This provision applies where the transferee receives a qualifying statement from the Secretary, which takes the form of a withholding certificate, applied for by either the transferor or the transferee.[33]

If the certificate is obtained prior to a transfer, it notifies the transferee that the withholding is to be reduced, eliminated or made on the special basis provided therein. If the certificate is obtained after the transfer, it authorizes a normal or early refund. If the application for a withholding certificate is pending on the date of the transfer, the transferee is nevertheless obligated to withhold; and if application is submitted at least 30 days prior to the transfer, the transfer is not required to withhold and pay over until the 10th day following the IRS's determination.[34]

Prudence dictates a withholding escrow, since the transferee funds his secondary liability securely and the transferor assures speedy refund of any excess liability.

A request for a qualifying statement/withholding certificate will be acted upon within 90 days of receipt.[35] Applications have no mandated form, but must contain identification of parties to the transaction, as set forth in Temp. Regs. § 1445-3T(b)(1)-(3).[36]

Reasons for applying for a withholding certificate include: (a) appropriateness of reduced withholding, in which case the application must include calculations of the maximum tax on the disposition, calculated in accordance with Temp. Reg. § 1.1445-3T(c)(2); the transferor's unsatisfied withholding liability, calculated in accordance with Temp. Reg. § 1.1445-3T(c)(3), and in the case of a request for a special reduction of tax, a statement of the relevant law and facts; (b) a claimed exemption from U.S. tax, based on a claim under either section 892 or an income tax treaty, not made inapplicable after 31 December 1984 by FIRPTA; and (c) a special agreement for payment of tax, which must provide an agreement to pay not only the tax, but interest thereon, and/or the transferor's maximum tax liability, as determined under Temp. Reg. § 1.1445-3T(c); plus a 25% surcharge securing interest and penalties.[37] Additionally, the agreement must provide security acceptable to the IRS, which would include a surety bond of a U.S. surety, bank or insurance company;[38] a bond secured by either U.S. government securities or a certified check drawn on a bank acceptable to the IRS;[39] and a letter of credit issued by a bank acceptable to the IRS.[40]

A transferee who defers withholding in reliance on application for a withholding certificate which has been applied for with *a* principal purpose of delaying payment, is liable for interest and penalties. The existence of *a* principal purpose is rebuttably presumed if the transferee applied for a withholding certificate based on the transferor's maximum tax liability and the liability is ultimately determined to be 90% or more of the amount otherwise required to be withheld and paid over.[41]

Another exemption applies where the amount realized by transferor of a USRPI is less than $ 300,000 and where the property is acquired by transferee for use as his own residence.[42] The conferees rejected the Senate proposal that the property thus acquired be the transferee's principal residence. However, the temporary regulations provide that the subject property will be considered as the transferee's residence only if he has definite plans to reside there for at least 50% of the number of days that the property is in use during the two 12-month-periods following the date of the sale.[43]

The exemption for acquiring traded stock applies to transfers of a class of stock regularly traded on an established securities market.[44] Note that the securities market in question need not be a domestic securities market.

28. Temp. Reg. § 1.1445-4T(c)(1).
29. Temp. Reg. § 1445-4T(c)(2).
30. Section 1445(d)(2), Temp. Reg. § 1445-4T(e).
31. Treas. Reg. § 1.1445-2T(b)(4)(iv), 1.445-4T(d).
32. Section 1445(b)(4).
33. Temp. Reg. § 1445-3T, passim.
34. Temp. Reg. § 1.1445-3T(a), 1.1445-3T(f).
35. Section 1445(c)(3)(B).
36. See, e.g., Rev. Proc. 85-41, 1985-35 I.R.B.
37. Temp. Reg. § 1.1445-3T(e)(2)(iii).
38. Temp. Reg. § 1.1445-3T(e)(3)(ii).
39. Temp. Reg. § 1.1445-3T(e)(3)(iii).
40. Temp. Reg. § 1.1445-3T(e)(2)(iv).
41. Temp. Reg. § 1.1445-1T(c)(2)(iii).
42. Section 1445(b)(5).
43. Temp. Reg. § 1.1445-2T(d)(1).
44. Section 1445(b)(6).

COORDINATION WITH NON-RECOGNITION PROVISIONS

No withholding is required if: (a) the transferor notifies the transferee that by virtue of a Code or treaty provision, the transferor is not required to recognize gain or loss on the transfer; and (b) the transferee forwards the notice of non-recognition treatment to the IRS in Washington within 10 days of the transfer.[45]

No specific form is required for a notice of non-recognition treatment, but it must be verified under penalty of perjury and must contain transactional information and a summary of the law and the facts supporting non-recognition. A notice of non-recognition treatment may not be relied upon where not all of the gain is subject to non-recognition treatment; where the transferee knows or has reason to know that the transferor is not entitled to non-recognition treatment; and where the transferee and transferor are related pursuant to Treas. Reg. § 1.897-1(i). Note that this latter requirement, if literally applied, excludes, in practical effect, section 351 and 721 transactions. The experience of some practitioners suggests, however, that where the interest received in a related party, non-recognition transaction, will itself be subject to tax on disposition, withholding will be excused.

SPECIAL FORECLOSURE RULES

A transferee acquiring a USRPI through repossession or foreclosure under a mortgage, security agreement, deed of trust, or the like may withhold at the lesser of 10% of the amount realized by the transferor/debtor over the debts secured by the property at the time of foreclosure.[46] The transferee must file a notice with the IRS in Washington by the 10th day after the transfer; and while no form is prescribed, Temp. Reg. § 1.1445-2T(d)(3)(ii) sets forth the requirements for the notice, including the amount of the debt and the fair market value of the property.

The transferee may not rely on this rule if *a* principal purpose of the transaction was to avoid section 1445(a) withholding.[47] Existence of a principal purpose is rebuttably presumed if the security agreement did not arise in connection with the acquisition, improvement, or maintenance of the property; and the total amount of all debts secured by the property exceeds 90% of its fair market value. This rule is not applicable to deeds in lieu of foreclosure.

REITs are treated as trusts, and the withholding rules of Temp. Reg.§ 1.1445-5T(c)(3)apply.[48] In the case of corporate REITs, the board is treated as the trustee. However, a REIT will be treated as a trust only if it is a trust, for purposes of withholding under sections 1445(a), 1445(e)(4), and 1445(e)(5).[49] Thus, withholding may be required on transfers of interests in REITs that constitute USRPIs under section 1445(a).

Special rules apply to partnerships or trusts with more than 100 partners or beneficiaries.[50] Until 1 July 1985, these entities could assume, absent actual knowledge to the contrary, that a partner or beneficiary with a U.S. mailing address is a U.S. person. If these entities were publicly traded, the presumption applied through 31 December 1985. Thereafter, the entity is required to withhold with respect to partners and beneficiaries that cannot deliver a non-foreign certification or otherwise establish non-foreign status.

In lieu of withholding at the time of disposition of a USRPI, the entity may withhold on distributions at the rate of 20% for individuals and 28% for corporations on the gain realized. The election is made by filing a notice with the IRS in Washington, for which there is no prescribed form but which sets forth the information required in Temp. Reg. § 1.1445-5T(c)(iii)(C).

REPORTING

Reporting will continue to be required of foreign persons holding direct investments in USRPIs for the calendar year, if: (a) those foreign persons are not engaged in trade or business in the United States during the calendar year; and (b) the fair market value of the subject property equals or exceeds $ 50,000.[51]

Attribution rules to be further articulated in future regulations provide that interests held by partnerships, estates and trusts are treated as being owned proportionately by their partners and beneficiaries, as the case may be; and interests held by the spouse and/or minor child of an individual are treated as being owned by such individual.[52]

Returns to be filed at the time and in the manner required by regulations yet to be issued will set forth the name and address of the foreign person holding the direct investment in the USRPI; a description of all USRPIs held by such person at any time during the calendar year; and such other information as the Secretary shall prescribe by regulations,[53] previously issued regulations under section 6039C having been withdrawn.

EFFECTIVE DATES

Withholding provisions generally apply to dispositions of USRPIs after 1 January 1985, except that, as noted above, the transfer of certain entity interests is not subject to withholding until the effectiveness of regulations dealing with their taxability under FIRPTA. Reporting provisions apply to calendar year 1980 and subsequent calendar years.

45. Temp. Reg. § 1.1445-2T(d)(2).
46. Temp. Reg. § 1.1445-2T(d)(2)(iii).
47. Temp. Reg. § 1.1445-2T(d)(3)(iv).
48. Temp. Reg. § 1.1445-5T(c)(4).
49. See text accompanying fns. 20-23, above.
50. Temp. Reg. § 1.1445-5F(c)(3).
51. Section 6039C(b).
52. Section 6039C(c)(3).
53. Section 6039C(a).

CONCLUSION

The withholding mechanism for collecting the tax imposed by FIRPTA must be viewed in historical context. Section 1445 replaces a reporting regime for collection of the tax, whose labyrinthine complexity was articulated in the withdrawn regulations to the reporting section, section 6039C. These reporting requirements were often duplicative and always complex. Additionally, in some cases, they compelled foreign investors to make incriminating admissions vis-à-vis their home countries as to items that were tangential to determining their U.S. tax liability. Finally, as the IRS ultimately recognized, the reporting requirements were administratively unworkable.

By contrast, the withholding regime of section 1445 is fairly straightforward. The temporary regulations are, in most cases, logical, sensible, and workable. In those limited cases where they are not, i.e. non-recognition transactions, administrative flexibility should smooth an otherwise tortuous path.

[continued from page 362]

The Conference was inaugurated by the Union Law Minister, Mr. Asoke K. Sen. It was attended by 136 delegates representing leading public and private sector companies, the Ministry of Finance, the Government of India and the Diplomatic Missions in New Delhi. IFA and its Indian Branch received wide press coverage reporting on the Conference.

Seminar in Nepal

At the time of submitting the Annual Report 1985 the India Branch was organising, together with the Institute of Productivity and Management, UP, a Seminar on "Strategies for corporate tax and investment planning", following recent changes in Government policies from 19 through 24 June 1986 in Kathmandu (Nepal).

Developments in the India Branch

The India Branch was founded on 3 June 1983. In 1984 it had 19 corporate and 34 individual members. These numbers increased to 25 corporate and 43 individual members in 1985. Of course, there is a tremendous potential for further growth and efforts are being made to make IFA more widely known in India, e.g. by organising regional meetings to which senior finance and tax managers of companies are invited.

The Indian IFA Branch is led by an Executive Committee consisting of 11 members. Its officers, which are charged with the day-to-day management, are currently Messrs. O.P. Vaish (Chairman), Subodh Chandra (Vice-Chairman), N.S. Jain (Secretary), and G.C. Jain (Treasurer).

SWISS BRANCH

1985 Report

The number of individual members increased from 292 to 314 and corporate membership from 73 to 76.

In 1985 the Swiss Branch of IFA met on 7 February, 13 June and 14 November. Apart from organizational matters, recent national and international tax problems were discussed.

Meeting of 7 February 1985

This meeting, which was held in Basel, was dedicated to practical experience with international mutual administrative assistance in tax matters. Mr. A. Keller, from the Federal Revenue Service (Division for International Tax Law and Tax Treaties), lectured on international mutual administrative assistance under tax treaties; Dr. L. Frei, from the Federal Police Department (Division for International Mutual Legal Assistance), spoke on the delimitation of tax fraud and tax evasion; Dr. B. Trinkler, Chief State Attorney of the Canton of Zurich, spoke on the practic regarding the application of the Law on international assistance in criminal matters by the cantonal authorities; Prof. Dr. G. Broggini, Professor at the University Cattolica di Milano, covered the international exchange of information; and Mr. R van Siebenthal, deputy director of the ATAG, Allgemeine Treuhand A.G., Bern, discussed the response from abroad to new Swiss developments.

Meeting of 14 June 1985

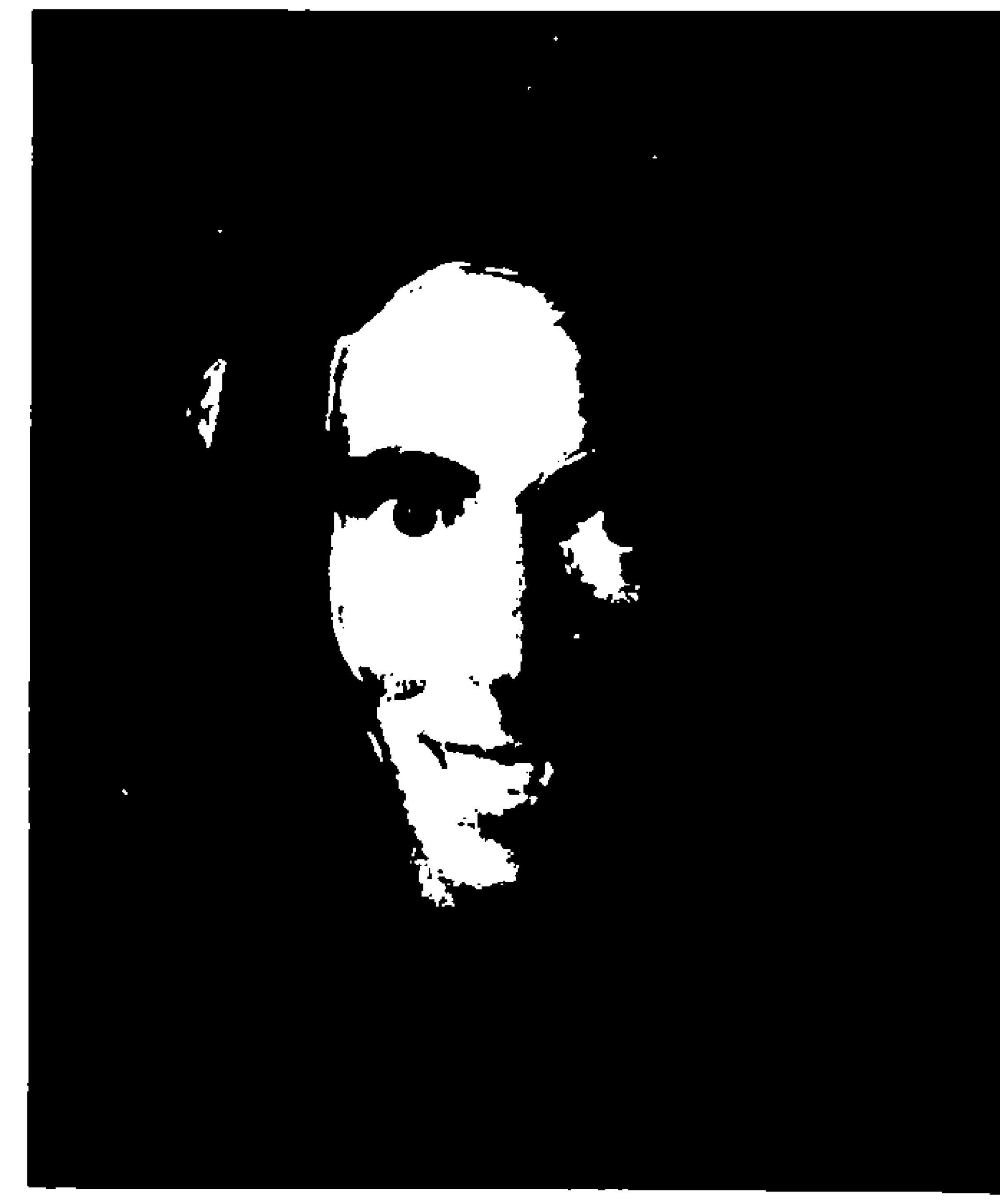
During the June meeting, held in Zurich, the subject of the taxation of married and unmarried couples was discussed. Prof.Dr. D. Yersin lectured on the theory and the actual legal situation regarding couples; and Prof.Dr. P. Locher spoke on the pilot decision of the Bundesgericht (Federal Court) dealing with the taxation of married couples. The subsequent panel discussion was chaired by Prof.Dr. P. Böckli. Prof.Dr. R. Rhinow and Mr. F. Fessler, Director of the Cantonal Tax Office of Zurich, participated on the panel.

Meeting of 15 November 1985

Messrs. R. Pennone, member of the Board of Société Anonyme de Revision et d'Expertise Fiscale, and P. Gillioz (attorney) reported on the subjects discussed at the 1985 London IFA Congress. The reports for the 1986 New York IFA Congress were submitted by the national reporters, i.e. Messrs. P. Spori and R. von Siebenthal, director and deputy director of the ATAG, Allgemeine Treuhand AG, Bern, respectively, on Subject I (Transfer of assets into and out of a taxing jurisdiction) and Mr. B. Schnider, director of Arthur Andersen AG, Zurich, on Subject II (Currency fluctuations and international double taxation). During the last part of the meeting Mrs. G. Laffely of the Cantonal Tax Office of Lausanne lectured on the tax provisions of the law on social security for free professions.

[continued on page 412]

Determination of Residency of Alien Individuals for U.S. Federal Income Tax Purposes



By Barbara M. Zak

INTRODUCTION AND HISTORICAL BACKGROUND

Prior to the Tax Reform Act of 1984 ("Act"), the U.S. Federal Internal Revenue Code of 1954, as amended ("Code") did not define the terms "resident alien" or "non-resident alien for income tax purposes." Consequently, the determination of an alien's residency was left largely to the courts, where the issue was resolved under an inexact "facts and circumstances" test in which an analysis of many elements was considered. Typically, an examination was made of an alien's assets and activities within the United States compared to his or her assets and activities elsewhere. Various factors considered often included: time spent in the United States; immigration status; the purchase of a home or long-term lease; marital status and residence of the alien's family; situs of clothing and personal possessions; participation in community activities; telephone listing; U.S. driver's license and registration of automobiles; and participation in U.S. business ventures. No one factor was consistently treated as controlling. A completely different test of U.S. residency partially based on the English Common Law concept of domicile was used for U.S. federal estate and gift tax purposes.

One of the most important concepts under prior federal income tax law, and the one which would eventually be changed under the Act, was the principle that determination of residency for U.S. federal income tax purposes is made separately from the determination of residency for immigration purposes. While the U.S. Internal Revenue Service ("IRS") took the position that, while an alien's visa classification was not necessarily determinative of an alien's status for tax purposes, it was treated as evidence of his or her intent, purpose, and activity. Rev. Rul. 58-144, 1958-1 C.B. 260. However, an alien whose stay was limited to a definite period by the immigration laws was not a resident alien absent "exceptional circumstances." Treas. Reg. Section 1.871-2(b). See *Tongsun Park v. Commissioner,* 79 T.C. 17 (1982), where the U.S. Tax Court found such exceptional circumstances. See also, Rev. Rul. 81-70, 1981-1 C.B. 389, holding that an alien who lived illegally in the United States for eight years was a resident of the U.S. for federal income tax purposes.

While the U.S. federal income tax system subjects a resident alien to tax on his or her worldwide income in a similar manner as a U.S. citizen, i.e., on "income from all sources, wherever derived" (Section 61), a non-resident alien is taxed only on income from sources within the United States and on certain income "effectively connected with" (or attributable to) the conduct of a trade or business within the United States. The worldwide income less allowable deductions of a resident alien is subject to U.S. federal income tax at the regular graduated rates. A non-resident alien's passive U.S. source income is subject to tax at a flat 30% rate withheld at source (unless reduced by an applicable income tax treaty), while effectively connected income is generally subject to taxation on a net basis at graduated rates. Consequently, an individual's classification as a resident or non-resident alien for U.S. federal income tax purposes may have significant financial consequences.

Barbara M. Zak is an attorney with Finley, Kumble, Wagner, Heine, Underberg & Manley, Beverly Hills, California. Her areas of practice include international tax planning for domestic and foreign corporations, and non-resident individuals. In addition, she teaches international business law and international tax planning at UCLA.

Ms. Zak received a J.D. degree from the University of California, Hastings College of the Law. She received an A.B. from the University of Michigan, where she was elected to Phi Beta Kappa. She also received a Master's Degree (M.A.) in Latin American Studies from Stanford University, where she was the recipient of a Fellowship in International Studies.

From 1975 to 1976, Ms. Zak served as Editor of *Corporate Taxation in Latin America* (a comprehensive loose-leaf service on Latin American taxation) at the International Bureau of Fiscal Documentation in Amsterdam, the Netherlands.

Ms. Zak is a member of the State Bar of California, Taxation Section (Member of Executive Committee), the International Law Section of the American Bar Association (International Taxation Committee, Inter-American Law Committee), the Taxation Section of the American Bar Association (Committee on Foreign Activities of U.S. Taxpayers, Foreign Tax Credit Subcommittee) as well as many other Committees.

THE NEW RULES

To alleviate much of the uncertainty surrounding the determination of residence status and its resulting income tax consequences, Congress believed that the U.S. federal income tax laws should provide a more objective definition of residence for U.S. federal income tax purposes. See *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984* (prepared by the Staff of the Joint Committee on Taxation, 31 December 1984). An objective definition might allow some aliens who should, as a matter of policy, be taxable as residents to avoid resident status, and might impose resident status on some aliens who were not residents under the former rules. Nevertheless, Congress determined that the certainty provided by the Act's objective definition outweighed other considerations. Section 138 of the Act amended Section 7701 of the Code by adding a new Section 7701(b) to define both resident alien and non-resident alien for U.S. federal income tax purposes. No change was made in the definition of residency (domicile) for federal estate and gift tax purposes.

Essentially, under new Section 7701, immigration and tax concepts are integrated for the first time. For taxable years beginning after 31 December 1984, the new rules are applied to determine whether an alien individual is a resident of the United States for U.S. federal income tax purposes. The rules provide that an alien individual shall be treated as a resident with respect to any calendar year only if such an individual satisfies either of two tests: (1) the lawful permanent residence ("green card") test or (2) the substantial presence test. An alien who has not established his or her taxable year is treated as having the calendar year for this purpose. An alien who has properly elected a fiscal year for U.S. federal income tax purposes will be treated as a resident in any portion of his or her own fiscal year that is within any part of the calendar year the lawful permanent residence test is satisfied.

LAWFUL PERMANENT RESIDENCE TEST

Beginning in 1985, an alien individual is considered to be a resident of the United States for federal income tax purposes if he or she is a "lawful permanent resident of the United States" at any time during the calendar year. Section 7701(b)(1)(A)(1). For this purpose, the individual is a lawful resident of the United States if he or she has the privilege of residing permanently in the United States as an immigrant under the U.S. immigration laws (holds a "green card") and his or her status has not been revoked or administratively or judicially determined to have been abandoned. Section 7701(b)(5). Under the special transitional rule, an alien who held a green card at any time during 1984 will be a resident for federal income tax purposes in 1985 (and subsequent years) without being physically present in the United States in 1985 (and subsequent years).

In the case of an individual who is a lawful permanent resident of the United States at any time during the calendar year beginning in 1985, the starting date for his or her residency for federal income tax purposes (except under circumstances where a special transitional rule applies) is the first day in the calendar year on which he or she is physically present in the United States as a lawful permanent resident. Section 7701(b)(2)(A)(ii). He or she will remain a resident until he or she surrenders his or her green card *and* abandons his or her claim of permanent residency under the U.S. immigration laws. Section 7701(b)(2)(B). Once residency is established for U.S. federal income tax purposes, an alien individual will continue to be treated as a resident until the last day of the given calendar year on which he or she was a lawful permanent resident provided he or she establishes a closer connection to a foreign country and he or she does not become a resident of the United States for federal income tax purposes in the immediately succeeding calendar year.

SUBSTANTIAL PHYSICAL PRESENCE TEST

An alien individual is also treated as a resident for U.S. federal income tax purposes in any calendar year that he or she is present in the United States for a substantial period during the calendar year as determined under a special three-year weighted average formula. If the special transitional rules described below for the years 1985 and 1986 do not apply, an alien individual will be considered to have satisfied the substantial presence test in a given calendar year if (a) the number of days the individual is present in the United States during the current calendar year; plus one third of the days in the immediately preceding calendar year; plus one sixth of the days in the second preceding calendar year, equals or exceeds 183 days and (b) during the given calendar year the individual was present in the United States at least 31 days. For most aliens, this general rule does not become fully applicable until calendar year 1987. Section 7701(b)(3). Act Section 138(b)(1)(A)(ii).

Only an alien who was resident at the close of both calendar years 1983 and 1984 under the prior law (or the special physical presence rule for green card holders in 1984) will have his or her residency status determined in calendar year 1985 (and subsequent years) under the general three-year rule described above. If an individual was a resident of the United States as of the close of 1984, but was not a resident of the United States as of the close of 1983 under the rules applicable for those years, the determination of his or her residency for 1985 and 1986 under the physical presence test, but not the lawful permanent residence (green card) test will be made by counting only the days in 1984 and subsequent years as provided under the formula. For purposes of this special transitional rule in determining residency in 1985 and 1986, an alien will be treated as a resident for calendar year 1984 (regardless of his or her actual reporting status) for that year if he or she was a lawful permanent resident of the

United States throughout the year or he or she was present in the United States at any time in 1984 while he or she was a lawful permanent resident.

The transitional rules for 1985 and 1986 are illustrated by two examples. If a non-resident was a resident at the close of 1984, but not 1983, he or she is a resident for U.S. federal income tax purposes in 1985 only if (a) he or she was present in 1985 for at least 31 days and (b) the sum of the days present in 1985 plus one third of the days present in 1984 equals or exceeds 183. Under the same circumstances, he or she would be a resident for federal income tax purposes in 1986 only if (a) he or she was present in 1986 for at least 31 days and (b) the sum of the days present in 1985 plus one third of the days present in 1985 plus one sixth of the days present in 1984 equals or exceeds 183 days.

If the individual was *not* a resident of the United States as of the close of calendar year 1984 as determined under prior law or under the special deemed residence rule, the determination of whether the individual will be treated as satisfying the substantial presence test is made by taking into account only the days present in the United States after 1985. Act Section 138(b)(2)(A). For 1985, an alien individual who was not a resident of the United States for federal income tax purposes in 1983 or 1984 actually or under the deemed residence rule is treated as a resident only if he or she is present in the United States in 1985 for at least 183 days. For 1986, an alien individual who was not a resident of the United States in 1984 is treated as a resident of the United States only if (a) he or she is present in the United States for at least 31 days in 1986 and (b) the sum of the days present in the United States in 1986 plus one third of the days present in 1985 equals or exceeds 183 days. For 1987, the alien individual will be a resident of the United States only if (a) he or she is present in 1987 for at least 31 days and (b) the sum of the days present in the United States in 1987 plus one third of the days present in 1986 plus one sixth of the days present in 1985 exceeds 183 days. The rules for 1988 and subsequent years are applied as described for 1987.

For the first year in which the substantial physical presence test is satisfied, the starting date shall be the first day he or she is present in the United States other than during a time not to exceed 10 days if he or she maintained a closer connection to a foreign country. If an alien individual has established his or her U.S. residency under the physical presence test, he or she may establish non-residency for that year only by establishing a closer connection to a foreign country, remain physically present in the United States for 10 or less days for any period thereafter and not become a U.S. resident in the immediately succeeding calendar year.

SAFE HAVENS UNDER THE PHYSICAL PRESENCE TEST

A number of "safe havens" are provided under which an alien individual who does not hold a "green card" in a given taxable year may establish that he or she is not a resident of the United States. The safe havens are available even though the individual satisfies the substantial presence test described above. However, the "safe havens" are *not* available to an alien who satisfies the lawful permanent residence ("green card") test. These special safe havens are as follows:

a. The individual is not treated as satisfying the substantial presence test for a given calendar year if (i) he or she is present in the United States for less than 183 days in the calendar year, (ii) he or she has established a "tax home" in a foreign country (essentially the place where the individual maintains his or her regular or principal place of business), (iii) he or she has a closer connection to such foreign country than to the United States *and* (iv) he or she has neither made application for adjustment of status nor taken steps to apply for status as a lawful permanent resident of the United States. Section 7701(b)(3)(B). Since an individual must show a closer connection to another country through "all the facts and circumstances", the old subjective standard Congress sought to eliminate in the residency area has been preserved, albeit for limited purposes.

b. The individual will not be treated as present in the United States on any day if he or she is a "foreign government-related individual". Section 7701(b)(4)(B). This applies to any individual who is temporarily present in the United States by reason of a diplomatic status or visa which the IRS, after consultation with the Secretary of State, determines represents *full time* diplomatic or counselor status; to any individual who is a full time employee of an international organization; or anyone who is a member of the immediate family of such a diplomatic or international organization employee.

c. An alien individual will not be treated as physically present in the United States if he or she is temporarily present in the United States under a J visa relating to teachers or trainees temporarily admitted to the United States. Section 7701(b)(4)(C). However, an alien individual claiming an exemption as a teacher or trainee will nevertheless be treated as physically present in the United States if for any two of the six preceding calendar years he or she did not count his or her presence in the United States because of the exemption applicable to either students, teachers, or trainees.

d. An alien individual would not be treated as physically present in the United States if (i) he or she is temporarily present in the United States by reason of being a "full time" student admitted under a F or J visa and (ii) he or she has substantially complied with the requirements for being so present. In each calendar year after the fifth calendar year in which the individual claims an exemption as either a student, teacher, or trainee he or she will be required to establish that he or she does not intend to permanently reside in the United States and that he or she meets the requirements described above. Section 7701(b)(4)(E).

Except as provided below, an individual who is present in the United States at any time on any day is treated as present in the United States on that day for this purpose. A number of special mechanical rules are provided for determining whether the physical presence test has been satisfied in given circumstances as follows:

a. The days during which an alien individual is unable to leave the United States because of a medical condition of his or her own that arose while such individual is present in the United States will not be counted toward the 183-day requirement. Section 7701(b)(3)(B).

b. An alien is not present in the United States while he or she is in transit between two points outside of the United States and physically present in the United States for *less than* 24 hours. Section 7701(b)(6)(C).

c. An alien who regularly commutes to employment or self-employment in the United States from his or her place of residence in Canada or Mexico is not treated as present in the United States on any day in which he or she is commuting. Section 7701(b)(6)(B).

SPECIAL TAX REGIME FOR EXPATRIATE RESIDENT ALIEN

A special U.S. federal tax regime applies to a resident alien who after having been a resident for U.S. federal income tax purposes for three or more consecutive calendar years ceases to be a resident of the United States and subsequently within three calendar years thereafter reestablishes his or her residency for U.S. federal income tax purposes. During the intervening period while he or she is a non-resident of the United States (up to a three-year period), he or she is subject to special federal income tax treatment of the following items of gross income:

a. Gross income derived from dividends paid by a domestic (U.S.) corporation without substantial foreign operations and by a foreign corporation with substantial U.S. operations;

b. Gross income from interest paid by a domestic (U.S.) corporation without substantial foreign operations and a foreign corporation with substantial U.S. operations and by any other U.S. resident;

c. Other fixed determinable and periodic gross income derived from sources within the United States and other than portfolio interest (interest from bank accounts holding funds not used in U.S. business activities) and income otherwise exempt from federal income tax in the hands of a U.S. taxpayer; and

d. Gains from the sale or exchange of shares of a domestic (U.S.) corporation and debt obligations of a U.S. person whether or not such interests are U.S. real property interests.

Essentially, such a non-resident is subject to U.S. federal income tax imposed on his or her net income from U.S. sources under a graduated rate schedule rather than a flat tax imposed on gross income (without deductions) at a 30% rate or a reduced rate as provided by an applicable income tax treaty. During the intervening period of non-residency, the transitional non-resident is subject to tax on certain portfolio income and capital gains derived from U.S. sources which otherwise would be exempt in the hands of a non-resident alien. Such individuals would appear to be eligible to claim benefits under any applicable income tax treaty.

TAX TREATY CONSIDERATIONS

A majority of the U.S. income tax treaties signed in the last 20 years contain articles defining "residence", with "tie-breaker" rules under which the situation of dual residents can be resolved. However, the tie-breaker rules determine residence *only* for purposes of the particular treaty and not for general (non-treaty) purposes of the Code. In other words, the treaty article supersedes the Code only to the extent that the treaty covers a particular item of income which is affected by the residency status of the recipient. Generally, the treaty contains provisions which merely provide that certain classes of income will be subject to tax in the country of source. Even though Congress apparently did not intend for the new residency rules to override treaty obligations with respect to the "tie-breaker" rules (See *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984,* supra), the Act treats the alien as a U.S. resident for purposes of the internal laws of the United States. Thus, the treaty non-resident/statutory resident could be considered a U.S. person with respect to the application of certain "indirect taxes".

If aliens who are non-residents for treaty purposes, but are residents for Code purposes, own more than 50% of the voting power of a foreign corporation, the corporation will be a controlled foreign corporation. Certain categories of income less allocable deductions are attributable, whether or not distributed, to shareholders of 10% or more who are U.S. citizens or residents. The U.S. income tax treaty with the alien's country may prevent U.S. taxation of the alien's share of undistributed earnings of the controlled foreign corporation. But, the United States will apply its regular rules in determining the U.S. federal income tax consequences to any U.S. citizen (or resident alien not protected by an applicable treaty) who is a minority 10% shareholder in that controlled foreign corporation. It is interesting to note, by contrast, that in its 29 March 1982 proposal to change the former residency rules, the Committee on U.S. Activities of Foreigners and Tax Treaties of the American Bar Association recommended the adoption of a special rule limiting the application of the "indirect taxes" of Sections 531, 541, 551, 679 or 957 under these circumstances.

PLANNING OPPORTUNITIES

A significant number of aliens have become residents of the United States without undertaking advance planning. Opportunities still exist for these individuals for 1987. He or she may plan to avoid satisfying either of the two basic tests for residency in 1987. This requires the surrendering of any "green card" to the appropriate U.S. consular official and avoiding the requisite physical presence in the United States for 1987. In addition, these individuals should take appropriate action before 1987 to avoid the application of the special three-year alien expatriation rules described above. Even if personal circumstances prevent the establishment of non-resident status for U.S. federal income tax purposes in 1987, tax planning may still be possible if U.S. residence for estate and gift tax purposes has not yet been established. Assets other than real property, cash, or personal property located in the United States may be given to non-resident alien family members or to appropriately drafted trusts. The income subsequently derived from such assets may then avoid U.S. taxation.

Aliens who wish to continue non-resident status for U.S. federal income tax purposes should consider the following simple strategy:

(a) do not apply for United States permanent residence ("green card") status; and
(b) do not stay in the United States (including Hawaii and Alaska) more than 120 full or partial days in any given calendar year.

Under the new law, there is no way to hold a green card and avoid U.S. residence for income tax purposes. However, planning latitude is permitted with regard to physical presence in the United States. For example, an alien who has never been physically present in the United States after 31 December 1984 may, without adverse consequences, stay in the United States for up to 182 days in 1986. However, under such circumstances, he or she could stay only 122 days in 1987, but only 29 days in 1988 (assuming the stays in prior years were the maximum length permitted). Long term flexibility is greatest under the 120-day plan described above.

An alien who knows that he or she will become a resident for U.S. tax purposes should consider certain advance tax planning steps. The alien should consider selling or giving away to family members assets whose current value exceeds their original cost. Ownership interests in foreign (non-U.S.) corporations should perhaps be restructured to avoid status as a controlled foreign corporation once U.S. income residence is established. Burdensome reporting requirements and tax liabilities may be imposed on U.S. residents who are shareholders of a controlled foreign corporation. Reporting of foreign bank accounts to the U.S. Department of Treasury may also be avoided by pre-residency restructuring. Consideration should be given to the domestication of foreign trusts or renunciation of interests in such foreign trusts to avoid adverse U.S. tax liability and reporting consequences. The establishment of U.S. federal income tax residence may make it more difficult to avoid residence for U.S. federal estate and gift tax purposes. Hence, advance planning to reduce the size of an alien's prospective federal taxable estate may be in order. Such planning would involve pre-residency gifts and the implementation of various asset valuation freeze techniques such as installment sales and recapitalization of corporations.

Worldwide Combined Reporting – The End is in Sight –

By Leonard W. Rothschild, Jr.

In my first article on this subject (37 *Bulletin for International Fiscal Documentation* 2 (1983) at 59-64), I examined the unitary tax concept and its effect on foreign-based multinational companies, and described certain proposed Federal and state legislation. I concluded in that article that no further Federal or state legislative action would occur until after the U.S. Supreme Court decided the *Container Corporation of America* case.

In a subsequent article (38 *Bulletin for International Fiscal Documentation* 4 (1984) at 153-156), I explained the decision in *Container Corporation of America*, and described other developments such as the Worldwide Unitary Taxation Working Force, pending judicial action, and proposed Federal and state legislation. I concluded that although the *Container Corporation of America* decision was a serious set-back for domestic (U.S.) parent corporations, the decision did not affect foreign-based (non-U.S.) parent corporations. Furthermore, while I expressed a hope that Federal legislation would be enacted, I stated that the better and more likely solution would be for unilateral action by the states to abandon worldwide combined reporting.

Fortunately many states, in an effort to attract additional investment, have already taken legislative action to limit combined reporting to the "water's edge" (this includes taxing business activities only within the "water's edge" of the United States). This article will explain the positive action taken by a number of states, as well as to update the current legislative proposals and pending court cases that affect worldwide combined reporting.

CURRENT DEVELOPMENTS RELATING TO WORLDWIDE UNITARY TAXATION

As of 1 January 1986 seven states (Alaska, California, Idaho, Montana, New Hampshire, North Dakota, and Utah) required use of the unitary tax method with respect to an affiliated group's worldwide income. This method of taxation is vigorously opposed by the federal government, many foreign governments, and many multinational companies. As a result of the objections there has been considerable pressure on these seven states to modify the unitary method and limit its application to the "water's edge".

BACKGROUND

On 27 June 1983 the U.S. Supreme Court upheld California's worldwide combined reporting system of taxation as applied to a U.S. corporation and its foreign subsidiaries in *Container Corporation of America v. Franchise Tax Board*. A footnote in the decision stated that no opinion was being expressed on the constitutionality of the worldwide combined reporting system "with respect to state taxation of a domestic corporation with foreign parents."

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Mr. Rothschild is a member of the United States Branch of the International Fiscal Association, the California Council of International Trade, the San Francisco International Tax Group, and a co-founder of the San Francisco Foreign Tax Club. He is also a member of the American Institute of Certified Public Accountants, the California Society of Certified Public Accountants, and the State Bar of California.

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In order to address the objections of many foreign governments and multinational corporations, on 23 September 1983 the Administration announced the establishment of a Working Group was "charged with producing recommendations. . . that will be conducive to harmonious international economic relations, while also respecting the fiscal rights and privileges of the individual states." On 4 September 1984 the Final Report of the Worldwide Unitary Working Group was released. Although a consensus was not reached, the members of the Worldwide Unitary Taxation Working Group were in basic agreement on three principles:

1. Use of a water's edge unitary combination for both U.S. and foreign-based companies.
2. Increased federal administrative assistance and cooperation with the states to promote full taxpayer disclosure and accountability.
3. Competitive balance for U.S. multinationals, foreign multinationals, and purely domestic businesses.

Since the Working Group failed to reach a consensus, its only significant contribution was to provide a forum for debate, and to allow additional time for certain states to unilaterally act to modify their unitary tax legislation.

When it became apparent that the Working Group would not reach a consensus, the Treasury Secretary, on 31 July 1984, stated to President Reagan, "If there are not sufficient signs of appreciable progress by the states in this area by 31 July of next year [1985], whether by legislative or administrative action, I will recommend to you that the Administration propose federal legislation that would give effect to a water's edge limitation. . ."

In the meantime, the U.K. Budget that was released in March 1985 contained a provision enabling the U.K. Treasury to retaliate against U.S. states that assessed income tax on a worldwide unitary basis. The legislation gives the U.K. Treasury the power to deny a credit for advance corporation tax (ACT) on dividends paid by U.K. subsidiaries to certain U.S. parent companies that also operate in unitary states. Although the legislation could have been effective for dividends paid on or after 1 April 1985, the U.K. Government has announced that the legislation will not become effective any sooner than 1 January 1987. This is to allow U.S. states (or federal government) sufficient time to enact legislation in order to avoid U.K. retaliation.

In response to the U.K. legislation, threatened retaliatory legislation from other countries, and the failure of the Working Group to reach a meaningful consensus, the Treasury Department on 8 July 1985 issued for public comment proposed legislation that would provide federal administrative assistance to states that do not employ the worldwide unitary method. This proposal would permit the federal government to share new information obtained from multinational companies ("domestic spreadsheet" legislation).

It should be noted that in the one-year period ended 31 July 1985 five states ceased taxing on a worldwide basis (Colorado, Florida, Indiana, Massachusetts, and Oregon), and Utah issued regulations that would terminate its use of the worldwide unitary method upon implementation of the proposed federal legislation.

Notwithstanding the considerable progress made in eliminating worldwide unitary taxation, California and five other states had not enacted legislation to repeal worldwide unitary taxation. Therefore, on 8 November 1985 President Reagan instructed the Treasury Secretary to begin work on federal legislation to restrict the states' use of the unitary method with respect to worldwide combined reporting. The concept of the legislation would address the following two issues:

1. Provide that multinationals be taxed by states only on income derived from the Territory of the United States (the "water's edge" requirement); and
2. Address the question of equitable taxation of foreign-source dividends.

As part of the announcement President Reagan indicated that where appropriate the U.S. would enter into negotiations to amend double taxation agreements to eliminate the worldwide unitary method, would pursue enactment of the domestic spreadsheet legislation (the 8 July 1985 proposed legislation), and represent its interests in appropriate controversies and cases in the judicial system.

PROPOSED FEDERAL LEGISLATION (S. 1974)

On 18 December 1985 Senator Pete Wilson (R-California) introduced S.1974, which is the bill authored by the Treasury Secretary. This is now the primary bill on the federal level that would limit application of the worldwide unitary taxation method.

While there are some other proposals before Congress, S.1974 is the leading bill and the only bill likely to be seriously considered in 1986. This bill, in addition to limiting use of the worldwide unitary method of taxation and modifying the taxation of foreign-source dividends, incorporates the domestic spreadsheet legislation that was proposed on 8 July 1985 (with some modifications). S.1974 would be effective for taxable years beginning after 31 December 1986.

Under proposed section 7518, IRC, the states would be prohibited from requiring worldwide combined reporting from corporations which have less than $ 10,000,000 of business activity in the United States, *or* conducted less than 20% of their business within the United States in the last tax year. Instead, these foreign corporations would use the water's edge method. Therefore, a foreign parent corporation with a subsidiary in the United States would *not* be included in a worldwide combined report unless the foreign parent had either $ 10,000,000 of business activity in the United States or conducted 20% or more of its business activity in the United States in the last year.

Of course, the United States subsidiary would continue to be subject to state income tax.

However, a foreign corporation that carries on substantial economic activity and is not subject to a substantial foreign tax on its net income (as prescribed in regulations), could still be included in a worldwide combined report *unless* at least 50% of sales, 50% of payments for expenses (other than payments for intangible property), or 80% of all payments for expenses are made to related companies that can be included in a combined report.

The prohibition of requiring worldwide combined reporting would not apply if the taxpayer failed to comply with the domestic spreadsheet disclosure requirements of proposed section 6039A, IRC, or failed to provide information with respect to intercompany transactions with related parties. Furthermore, a state may permit a taxpayer to make an unconditional election to be taxed on a worldwide unitary basis.

Proposed section 7518(b), IRC, would modify the treatment of state taxation of foreign-source dividends. States would be required to adopt a method of taxation that would result in an "equitable" apportionment of the dividend. An "equitable" apportionment would include either an 85-percent dividend-received exclusion, or an exclusion of dividends received to the extent they are not subject to federal tax by reason of the foreign tax credit. Section 7518(b), IRC, would *not* apply to any tax imposed on a dividend by the state of commercial or legal domicile of the recipient. Therefore, if a California-based parent corporation received a dividend from its foreign subsidiary, the state of California could continue to tax the dividend in the same manner as under present law, since California is the state of commercial domicile of the recipient of the dividend. However, no other state (other than the state of incorporation) would be allowed to tax more than an "equitable" share of the dividend.

Proposed section 6039A, IRC, would require a "reporting corporation" to file within 180 days of the due date (including extensions) of its federal income tax return certain information with respect to its state tax liabilities, disclosure of its ownership interest in other corporations, and any other related information required by regulations. A "reporting corporation" would include a corporation required to file a federal income tax return for the taxable year, *and* that has at least $ 10,000,000 of business activity outside of the United States, *or* is subject to tax in at least two states and owns total assets with an original cost of at least $ 250,000,000 (at least $ 10,000,000 of which are located in the United States).

Failure to comply substantially with this new filing requirement will result in a $ 1,000 penalty. If, after notification, the failure to file continues for more than 90 days, the penalty increases $ 1,000 for every additional 30-day period to a maximum $ 25,000 charge on each taxable year unfiled for each "reporting corporation", e.g. if the return is late for 25 months or more, a 25,000 dollar penalty will apply. If the 1986 return is due 15 March 1987 but is never filed, a maximum penalty of 25,000 dollars will be assessed for that return. In addition, the affected states will be permitted to impose fines or penalties for negligence, fraud, or understatement of income or of tax liability.

Section 6013, IRC, would be amended to allow the information filed with the federal government to be made available to states for the purpose of administration of their tax laws. In addition, information filed by treaty countries with the federal government would be made available to the states to the extent allowed by the particular tax treaty.

While S.1974 would provide some relief from worldwide unitary taxation for foreign corporations not carrying on substantial business activity in the United States, multinational companies would be required to supply additional information on their operation and activities. Many of these companies believe this additional administrative burden is too great and oppose this aspect of the bill. The Governor of California is strongly opposed to this legislation, as he believes each state has the right to establish its own taxation policies and laws. It is expected that hearings on this bill will be held sometime this spring.

STATE LEGISLATION

Of the seven states that required use of the worldwide unitary tax method on 1 January 1986, most of the focus has been on the state of California. Several bills have been introduced in the California Legislature, but no single bill has the support of the foreign-based multinational companies, the domestic-based companies, and the Governor.

The foreign-based multinational companies are interested in a water's edge type bill, and the California Legislature would like to accommodate these companies. Both the Governor and the legislature believe that a water's edge bill would improve the business climate in California by attracting additional foreign investment to the state.

The domestic-based companies do not generally oppose the water's edge approach, but believe that if such legislation is adopted they will be at a competitive disadvantage in comparison with foreign-based companies. In order to achieve parity, the domestic-based companies want some relief from the taxation of dividends received from their foreign subsidiaries. The dividend relief provisions would dramatically increase the cost of any bill.

The Governor is not likely to sign a bill that grants significant dividend relief for domestic companies unless the lost revenue can be replaced. Some of the bills provide for an election fee (a fee to elect not to be taxed on the worldwide unitary method), or for a phase-in period which is dependent on the level of increased investment in California by companies favorably impacted by the bills. Both of these approaches to raising revenues are opposed by some foreign-based and domestic-based companies.

Since a unified coalition has not been achieved, the prospect for legislation in California does not appear favorable at the present time. The threat of federal legislation, however, could be instrumental in breaking the present stalemate if the legislation moves forward.

Fortunately, several of the other states have taken significant action in 1986 to move away from the worldwide unitary method to a water's edge method. It is very likely that legislation mandating use of the water's edge method will be enacted this year in Idaho, Montana, New Hampshire, and Utah.

LITIGATION

After the decision in *Container Corporation of America v. Franchise Tax Board*, several foreign-based parent corporations began litigation to challenge California's use of the worldwide unitary tax system on the grounds that this taxation violated the Foreign Commerce Clause and Supremacy Clauses of the U.S. Constitution. While it was initially difficult to achieve standing to litigate these issues outside of the state court system, two cases are now being jointly heard in an Illinois Federal District Court. These cases (*Alcan Aluminum Limited v. Franchise Tax Board* and *Imperial Chemical Industries PLC v. Franchise Tax Board*) are especially important, since the U.S. Justice Department has taken the extraordinary step of filing an amicus curiae ("friend of the court") brief in each case. This intervention by the Justice Department is consistent with President Reagan's instructions to the Treasury Secretary on 8 November 1985 and is the first time the federal government has taken a position with respect to litigation on the constitutionality of the worldwide unitary tax.

The Justice Department's 7 March 1986 amicus curiae brief argues:

> A state tax cannot be constitutionally applied to an instrumentality of foreign commerce if it interferes with the conduct of foreign policy in areas which the Federal Government must speak with one voice. The [California unitary] tax is unconstitutionally applied to the instrumentalities of foreign commerce as: (1) it impermissibly interferes with the conduct of foreign affairs by the Federal Executive; (2) it has caused conflicts between the United States and foreign nations and led to the adoption of retaliatory legislation; and (3) it contravenes established federal policy.

Since the facts in the cases are wholly stipulated, a decision is expected at any time. Irrespective of the decision it is very likely that the case will be appealed, and it is possible that the case could be granted certiorari by the U.S. Supreme Court directly from the Federal District Court. If this is done it may be possible to have a U.S. Supreme Court decision within one year.

A number of legal observers have speculated that the U.S. Supreme Court may hold the worldwide unitary tax unconstitutional as applied to a foreign-parent corporation on foreign policy grounds. (In *Japan Line, Ltd. v. County of Los Angeles*, the U.S. Supreme Court struck down a local property tax because it prevented the federal government from "speaking with one voice" with respect to foreign commerce.)

Several foreign-based parent corporations are continuing to litigate the worldwide unitary tax method in various state courts. The leading case is *Barclay's Bank v. Franchise Tax Board* which is in California Superior Court. It is understood that the Justice Department is expected to file an amicus curiae brief in this case. No action is expected in the *Barclay's Bank* case until later this year.

CONCLUSION

California (and other states) is under considerable pressure to abandon its worldwide unitary tax. There is a threat of federal legislation, as well as retaliation by the United Kingdom against companies doing business in California. Furthermore, now that the U.S. Government is actively protecting its interest in various court cases, it is more likely that the U.S. Supreme Court will rule on whether or not the worldwide unitary tax method is constitutional as applied to a foreign-based parent corporation.

With all of this activity it is clear that use of the worldwide unitary tax method is not likely to survive for more than a year or two. The exact timing will likely be determined by either the U.S. Supreme Court or the Congress, depending on which body first addresses this issue.

Currency Exchange Problems in California's Worldwide Unitary Taxation

By Roy E. Crawford

The author acknowledges with appreciation the contribution of R.W. Vickrey.

I. INTRODUCTION

Under the worldwide unitary business theory used by the State of California to determine the amount of income attributable to California by a corporation engaged in business in that state, all income determined to be earned in the context of a single economic enterprise is combined in a single measure of income subject to apportionment without regard to whether the business activities are conducted in one or more corporations or whether the corporations are domestic or foreign. A three factor apportionment formula consisting of property, payroll, and receipts is normally used to apportion part of the combined income pool to California. In *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159 (1983) the United States Supreme Court upheld the constitutionality of inclusion of foreign subsidiaries of U.S. parents in such a combined return. The Court expressly reserved the question whether a foreign parent and foreign subsidiaries of a foreign parent may be included in a combined return with a U.S. subsidiary. The California worldwide combined return requires computation of the pool of income and the apportionment formula in a single currency. This article examines currency exchange problems as applied in a worldwide unitary combined return, with particular emphasis on the effect on foreign parent combinations.

For U.S. federal income tax purposes five methods are used to translate books of account kept in foreign currency to U.S. dollars.[1] In brief, these methods are:

1. *Transaction*. Each individual transaction is translated into the reporting currency as it occurs. As a practical matter this method is used only where a reasonably limited number of transactions occur.

2. *Profit and loss*. Income is computed and books are maintained in local currency. Final results are translated at the exchange rate in effect at the end of the year.

3. *Net worth*. The difference between beginning and end-of-year balance sheets, translated into the reporting currency at the then current exchange rates, is reported as income or loss.

4. *Foreign corporation*. Income is reported only when a dividend is declared and repatriated.

5. *Combination method*. A portion of income of a subsidiary is treated as if earned by the parent company and is translated currently. Any other income accrues only as dividends are declared and repatriated.

Yet another translation method is used by U.S. parent companies for financial accounting purposes. In 1982 FASB 52 replaced FASB 8 as the standard for preparation of consolidated income statements including foreign subsidiaries. In *very general* terms, FASB 52 is similar to the profit and loss method in accounting for income in relatively low inflation foreign countries, while FASB 8 resembled the net worth method in that unrealized gains and losses in assets and liabilities were taken into account in current income.

Mr. Crawford (47) received a B.S. from the Wharton School of Finance, University of Pennsylvania (1960) and a LL.B. at the Stanford University Law School (1963). He was a member of the Board of Editors of the Stanford Law Review. After having served in the Judge Advocate General's Corps of the U.S. Army from 1964 to 1967, he joined the law office of Brobeck Phleger & Harrisson, San Francisco, California in 1967 where he became a partner in 1974. Mr. Crawford specializes in taxation matters, with emphasis on state and local taxation. He is a member of the American Bar Association (Chairman, State and Local Tax Committee, Taxation Section, 1979-1981; Member Joint Task Force on Interstate Taxation of Depositories (1978 to present)); as well as of the Tax Committee of the California State Bar Association and he is Certified Specialist (Taxation) at the California State Bar Association. He lectured on "California Taxes" (1977, 1981 and 1982) and on "Fundamentals of Federal Income Taxation" (1983) at the California Continuing Education of the Bar. He also lectured on "Interstate Taxation of Depositories" at the Annual Meeting of the Multistate Tax Commission (1980 and 1981); on "Taxation on Multi-State Banking Activities – California" at the ABA National Institute on Multi-State Banking (1984); on "Aspects of Formulary Taxation of Bank Income" at the Annual Meeting of the Multistate Tax Commission (1984); on "Aspects of Formulary Apportionment of Bank Income" at the Annual Meeting of the National Tax Association – Tax Institute of America (1984); on "Sales Taxation of Services", New York University, Third Annual Institute of State and Local Taxation (1984) and he is a lecturer at the Property Tax Institute (1985).

His publications include: "Sales and Use Taxes", *California Taxes*, California Continuing Education of the Bar, 1978; "California Law Provides for Refunds of Sales and Use Taxes Paid on Custom Computer Programs; Immediate Action Required", *Journal of State Taxation*, 1982; "Reorganization and Sale of Business", *California Taxation*, Matthew Bender, 1983 and "Taxation of Multi-State Banking Activities in California", ABA National Institute on Multi-State Banking, 1984.

He was admitted to the Supreme Court of California (1964); the Court of Military Appeals (1964); the U.S. Tax Court (1969); the U.S. District Court, Northern District of California (1971); the U.S. Claims Court (1974) and the U.S. Supreme Court (1979).

He is Special Counsel to the City of New York in restructuring New York bank income tax and an expert witness on California taxation in *Bank of British Columbia v. Her Majesty the Queen*.

1. See generally Donald R. Ravenscraft, *Taxation and Foreign Currency*, International Tax Program, The Law School of Harvard University.

II. CALIFORNIA APPORTIONMENT REGULATIONS

California has adopted a variation of the profit and loss method as the basis for determination of income accounted for in foreign currency. In practice, the choice was limited to the profit and loss method or the net worth method, as only these methods were considered adaptable to current accounting of income by a single entity.[2]

A. Determination of income subject to apportionment

The profit and loss method is adjusted in the regulations by modifying the deduction for depreciation, depletion, and amortization. Since under the profit and loss method only the bottom-line result is translated, and at year-end or average rates, the allowance for depreciation, depletion, and amortization can differ substantially from an allowance translated at historic exchange rate values where there has been a significant shift between the value of the foreign currency and the dollar. The regulation provides for translation of the allowance at historic exchange rates.

The adjustment to depreciation, depletion, and amortization is the only adjustment due to changes in the exchange rate expressly authorized in the regulations dealing with determining income subject to apportionment. However, the theory behind the adjustment applies to all items of income, expense, gain, or loss that are determined by reference to a cost basis that dates back to a prior transaction where the exchange rate differs from the current exchange rate. Similar problems of distortion arise in determining the amount of gain and loss on the sale of assets, the bad debt deduction, and in determining the cost of goods sold. Depending upon the nature of the business conducted by the taxpayer, these distortions can be far more significant than distortions from the allowance for depreciation, depletion and amortization.

An unresolved issue is whether the California Franchise Tax Board (the "Board") will allow an adjustment to income to reflect historic exchange rates in the determination of these other items of income and expense under the broad authority existing in California Revenue & Taxation Code §25137, the same section that is the authority for publication of the regulations involving foreign country operations.

The California regulations provide that exchange gains and losses will be reflected in income only when realized. Currency gains or losses on closed transactions are includible in income, but unrealized gains or losses resulting from restatement or revaluation of assets or liabilities to reflect changes in currency values are not taken into account. A closed transaction is defined as one where any foreign exchange position taken by a corporation has been terminated by exchanging the foreign currency for the currency in which the individual corporation maintains its books and records and normally conducts its business affairs. In the case of a borrowing in a foreign currency, the transaction is not deemed closed until repayment is made.[3]

B. Apportionment formula

Regulation §25137-6(c) provides for determination of the property factor in the apportionment formula, which is calculated at original cost, by translating property recorded in foreign currency at historic exchange rate values. The regulation specifically provides that inventories shall be translated at the exchange rate as of the date of acquisition. This provision may offer collateral support to the view that inventories should be translated at historic rates for income measurement as well as for determination of the property factor of the apportionment formula.

The regulations provide further that the factors of the apportionment formula shall be computed in the currency of the parent company unless the taxpayer requests and the Board determines that computing the factor in dollars or any other currency fairly reflects the taxpayer's activities in California. One view is that this part of the regulation was added only to provide administrative ease. However, as administered by the Board, problems can arise that cause distortion. For example, assume a French parent bank makes a single loan of four French francs when the exchange rate is 4 Ffrs. = $ 1.00. The U.S. subsidiary makes a loan in California of equal value of $ 1.00. The exchange rate in a subsequent taxable period is 8 Ffrs. = $ 1.00. To fairly reflect equal property values, the property factor should be 50%, calculated as 4 Ffrs. (the original exchange rate of the $ 1.00 California loan divided by 8 Ffrs. (the sum of the 4 Ffrs. loan and the $ 1.00 California loan translated at historic rates)). In the alternative, the 50% property factor could be calculated as $ 1.00 (the original California loan) divided by $ 2.00 (the sum of the $ 1.00 original California loan plus the 4 Ffrs. loan translated at the historic rate into $ 1.00). In practice, however, the Board has issued Notices of Proposed Assessment of Additional Franchise Tax in which the property factor would be calculated as 67%. This result is achieved by translating the $ 1.00 California loan at the current exchange rate of 8 Ffrs. = $ 1.00, but leaving the French loan as it is stated in the books at 4 Ffrs., so that the numerator is 8 Ffrs. while the denominator is 12 Ffrs.

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2. For a discussion of the analysis used by the California Franchise Tax Board in drafting its regulations for combination of foreign country operations, see Benjamin F. Miller, "Worldwide Unitary Combination: The California Practice", *The State Corporation Income Tax: Issues in Worldwide Unitary Combination, 148 at 152-158. The California regulations are reproduced in Appendix A.*
3. Regulation §25137-6(b)(3)(A)(ii).

III. ANALYSIS OF PROFIT AND LOSS TRANSLATION METHOD AS APPLIED TO FOREIGN PARENT COMBINATIONS

A. Theory of unitary return

The unitary theory, as it developed in the context of combination of domestic corporations in the United States, is based on the notion that all elements of a single economic enterprise contribute equally to profitability of the enterprise with respect to the relative amount of the apportionment factors present. The amount of income attributed to the taxing jurisdiction should not be affected by mere form or place of organization. The Board acknowledges that this principle applies to a combination of accounts kept in foreign currency. As stated by Mr. Miller in the article cited in footnote 2, a translation method must attempt to address the problem of providing identical results regardless of the principal domicile of the business.

A requisite ingredient to application of the unitary theory as an appropriate method of determining income of a U.S. subsidiary of a foreign parent corporation is that the translation rules used by the Board should provide identical results for business combinations headed in the United States with those headed in another country. Consider the results that obtain from three examples, accounting for (1) bad debt expense, (2) gain or loss on repayment of a loan, and (3) a foreign exchange transaction.

B. Application

1. Bad debt expense

Assume a French bank owns a subsidiary in the United States that engages in business in California, and that the bad debt deduction is based upon a specific charge off of a bad loan. In year one, the exchange rate is equal to 4 Ffrs. = $ 1.00. Two equal loans are made. One is a loan by the French parent for 4 Ffrs. and one is a loan by the U.S. subsidiary for $ 1.00. In year three the exchange rate is 8 Ffrs. = $ 1.00. Both loans go bad and are written off. The French loan produces a 4 Ffrs. bad debt loss deduction, and the U.S. loan produces a $ 1.00 bad debt loss deduction. Using the methodology used by the Board, the combined bad debt deduction is equal to 12 Ffrs., the sum of a 4 Ffrs. loss in the French bank, and a $ 1.00 loss in the U.S. bank translated into an 8 Ffrs. loss using the profit and loss translation method. By the same token, if the losses were translated into a functional currency of U.S. dollars, the combined bad debt loss would equal $ 1.50, which is the sum of the $ 1.00 U.S. loss and the 4 Ffrs. bad debt loss translated at a rate of 8 Ffrs. = $ 1.00.

It will be observed that the bad debt deduction is the same whether the franc or the dollar is treated as the reporting currency. In both cases, however, the banks loaned the equivalent of $ 2.00 and when the loans went bad, a bad debt deduction of only $ 1.50 is realized. A bank reporting income to California should be entitled to account for the loss on the same basis as a U.S. bank making loans in dollars so that the $ 2.00 loss produces a $ 2.00 deduction. If the U.S. subsidiary were regarded as the parent for purposes of combining income in a unitary tax return, equality of treatment would be afforded by allowing in addition to the bad debt loss an exchange loss of $ 0.50 on the bad debt in the French bank. In the alternative, the French bad debt could be accounted for at historic exchange rates, just as the depreciation deduction is.

2. Repayment of a loan

Continuing the example above, assume that a French bank makes a 4 Ffrs. loan, and a U.S. bank subsidiary makes a loan of $ 1.00, at the beginning of a year when the exchange rate is 4 Ffrs. = $ 1.00. At the end of the year the loans are repaid in full when the exchange rate is 8 Ffrs. = $ 1.00. Both loans are made out of equity capital, so that there is no offsetting or balanced currency position. Under the transaction method of accounting, in terms of dollars $ 2.00 were loaned. The repayment of the French loan at the end of the year returns only 4 Ffrs., which is translated into $ 0.50, producing an exchange loss of $0.50 in terms of dollar accounting.

Under the translation method applied by the Board, the separate books of the French parent and the U.S. subsidiary will show neither gain nor loss. When the separate results are combined for purposes of computing income subject to apportionment, the question arises whether there is a realized event, and whether there is an exchange gain or a loss.

The California regulations provide that no adjustment shall be made for unrealized gains or losses resulting from the restatement or revaluation of assets to reflect changes in currency values. (If FASB 52 were applied to the French parent there would be a realized exchange gain in the U.S. subsidiary; if FASB 52 were applied to the U.S. bank as if it were the parent, there would be a realized exchange loss in the French company.) The measure of taxable income used by the Board in preparing Notices of Proposed Assessment of Additional Franchise Tax does not treat these items as being realized. At least one claim for refund of tax has been filed with the Board based upon treatment of foreign parent loan repayments as events causing realization of income or loss. The Board has not yet acted on the claim for refund.

3. Foreign exchange transaction

Assume the French bank loans $ 1.00 when the exchange rate is 4 Ffrs. = $ 1.00, and that the loan is not balanced by any other transaction or liability in dollars. The loan is repaid when the exchange rate is 8 Ffrs. = $ 1.00. The French parent realizes an exchange gain of 4 Ffrs., or $ 0.50.

Note that a different result is obtained where the French parent loans $ 1.00, as contrasted to when the U.S. subsidiary loans $ 1.00. The French parent is considered to have realized an exchange gain, while repayment of an equivalent loan made by a subsidiary is not considered by the Board to produce a realized gain. Mere form of organization produces different results, in conflict with the underlying purpose of the unitary return concept.

C. Peculiar impact on foreign parents

Several observations may be made with respect to these examples as applied to foreign parent combinations.

1. Actual accounting practice

As a practical matter, tax returns filed by foreign parent corporations and Notices of Proposed Assessment of Additional Franchise Tax issued after audit by the Board may fail to take into account the historic exchange rate going into the cost of items expressed in terms of foreign currency. Even though the regulations expressly provide, for example, that the depreciation deduction in foreign currency should be determined on the basis of the historic dollar exchange rate, in actual practice this is not always done. At least in the early audits of foreign parent combinations, the practice instead was merely to take the bottom line profit, which includes as one element the deduction for depreciation, and translate it at current values.

The regulations provide that the foreign profit and loss statement shall be adjusted first to conform to U.S. accounting principles and then to conform to California tax accounting principles. Regulation §25137-6(b)(1) and (2)(A). At the present time it is not entirely clear whether the instruction that the foreign profit and loss statement shall be adjusted to conform to California tax accounting principles requires that where significant the original cost basis of foreign accounts shall be adjusted to reflect historic dollar exchange rates. If so, then the required adjustment of the depreciation deduction to reflect historic cost would be made as part of this adjustment, and no additional adjustment need be made to comply with that part of the regulation that specifies that the depreciation deduction shall be translated at historic values. Similarly, in the bad debt deduction example above, an adjustment might be required that would cause the bad debt deduction of 4 Ffrs. to be converted at the historic rate of 4 Ffrs. = $ 1.00, resulting in a theoretically proper foreign bad debt deduction of $ 1.00, which matches the similar U.S. bad debt deduction of $ 1.00, and provides a combined bad debt deduction of $ 2.00, the original dollar equivalent of the amount originally loaned.

2. Relative importance to foreign parents

The relative impact of the difference between the results obtained from the transaction method and the profit and loss method is usually substantially greater for a foreign parent than a domestic parent. In the usual course of events, most foreign parents conduct most of their business activity outside the U.S., while domestic parents conduct most of their business activity in the U.S.

The effect of changes in the exchange rate has a greater relative impact the higher the percentage of income not accounted for in terms of historic U.S. dollar rates. For example, if foreign currency loans were 90% of the total so that in the bad debt example above 36 Ffrs. and $ 1.00 were originally loaned (for a total of $ 10.00), the combined bad debt deduction would be 44 Ffrs. (36 Ffrs. plus $ 1.00 translated into 8 Ffrs.) or $ 5.50 if the methodology used by the Board were applied, but would be $ 10.00 if all loans were originally accounted for under the transaction method in dollars, a difference of $4.50. Contrast that with the result if foreign currency loans were only 10% of the total, so that 4 Ffrs. and $ 9.00 were originally loaned. The combined bad debt deduction would be 76 Ffrs. (4 Ffrs. plus $ 9.00 translated into 72Ffrs.) or $9.50 if the methodology used by the Board were applied, while remaining at $ 10.00 if all loans were originally accounted for in dollars, for a difference of $ 0.50. Because foreign denominated loans are relatively nine times more prevalent, the effect of changes in the exchange rate produces nine times the difference in results.

3. Balanced position

Many, if not most, multinational companies seek to limit exchange rate exposure by provision of an offsetting or balanced position.[4] (Many of the exchange issues that exist under federal law due to the existence of balanced positions do not arise in California, which does not distinguish between ordinary income and capital transactions.) A corporation offsets exchange exposure on the asset side by matching an exchange position on the liability side both as to amount and period. As a consequence, a domestic parent corporation can seek to reduce or substantially eliminate exchange risks in a foreign subsidiary. However, from the point of view of a foreign parent corporation with a U.S. subsidiary, the foreign currency exposure rests in dollars, not the unit of exchange of the parent. Thus, a British parent may seek to balance its dollar position, but is not likely to act in terms of balancing its position in sterling. It is highly unlikely that there will be a balanced risk between assets and liabilities due to the existence of equity capital in the parent corporation. If equity capital equals 5% of assets, 5% of assets can not be balanced by offsetting liabilities.

Under the profit and loss translation method used by the Board for determining income of a U.S. subsidiary of a foreign parent corporation, exchange gains and losses in the consolidated foreign income statement reflect gains or losses in unbalanced dollar position. In contrast, if the U.S. subsidiary were treated as the U.S. parent, and the foreign parent were treated as a foreign subsidiary, exchange gains and losses would

4. See generally Jill C. Pagan, "U.K. Taxation and Currency Fluctuations," 39 *Bulletin For International Fiscal Documentation*, 8-9, (1985) at 379.

arise from an unbalanced position in the currency of the foreign corporation, and by definition the foreign parent will almost always have an unbalanced position in its local currency.

The practical impact of this inherent imbalance in exchange exposure in a foreign parent corporation, viewed from a dollar based accounting system, is that the results obtained under the profit and loss translation method that include exchange gains and losses in the foreign parent (and in foreign subsidiaries of the foreign parent), and that are computed at the historic dollar exchange rate, will be random. The results will be dominated by exchange rate adjustments, particularly where there are wide swings in the exchange rate, and will afford a relatively poor measure of profitability of a corporation from its operations in California.

4. Realized gains and losses

The California regulations provide that only realized gains and losses resulting from restatement or revaluation of assets or liabilities to reflect changes or fluctuations in currency values may be taken into account. No definition is provided as to what constitutes a realized gain. Presumably, deferred exchange gains and losses in a foreign subsidiary are taken into account only on sale or liquidation of the subsidiary. In the case of a foreign parent with a U.S. subsidiary, it is difficult to conceive of an event that would qualify for recognition of gain or loss. To the extent that a deferred gain or loss exists in the currency of the foreign parent, as for example if one exists in the bad debt example above, the recognition event presumably would be sale or liquidation of the foreign parent corporation, where the deferred gain or loss exists, but sale of the stock of the foreign parent corporation would have no more tax effect on the income of the corporation than the sale of shares in the corporation on a stock exchange. In the absence of an event that could cause realization of gains and losses in a foreign parent, deferral of exchange gains and losses is not a satisfactory solution to the problem where different measures of income and expense exist depending upon whether the currency of the parent corporation is in dollars or in foreign currency.

5. Floating exchange rates and high inflation countries

The Board staff has observed that the relative value of the dollar with regard to the currency of the major U.S. trading partners has both gone up and down over the past 20 years. When the dollar is strong, more tax is paid under the translation rules used, and when the dollar is weak, less tax is paid. Taking all years together, rough equality may result. However, where a U.S. company is combined with a corporation that maintains its books in the currency of a consistently high inflation country, there is never an offsetting swing in rates. FASB 52 requires different accounting for consistently high inflation countries, defined as a three-year inflation rate of approximately 100% or more.

IV. CONCLUSION

The worldwide unitary combined tax return is viewed by the California Franchise Tax Board as only a tool to determine the California-source income of a corporation engaged in business in this state. Where distortions in income arise due to changes in the exchange rate, an appropriate inquiry is whether worldwide apportionment is a satisfactory tool. Apportionment of U.S. income as determined under federal rules is preferred by most foreign-based taxpayers, even though in some cases the actual effect is that *more* California tax will be paid on this basis. In the alternative, the Board should be prepared to allow adjustments to income, and should make significant administrative concessions regarding uses of averages and samples in calculating exchange losses in non-U.S. entities.

APPENDIX

[¶ 14-834F] Section 25137-6 [Reg. 25137-6-CCH.] *Combined Reports Including Foreign Country Operations.*-(a) In General.

(1) Unitary Business. A taxpayer is engaged in a unitary business (or a single business within the meaning of Reg. 25120(b)) when its activities within the state contribute to or are dependent upon its activities without the state. A unitary business exists when there is unity of ownership, unity of operation and unity of use.

(2) Translation Method for Determining Income. The translation method to be used for determining income shall be the "profit and loss method" as set forth in this regulation. This method excludes unrealized exchange rate gain or loss resulting from the restatement of assets or liabilities, while taking into account exchange gains or losses attributable to income transactions.

(3) General Applicability of UDITPA Regulations. The general regulations for UDITPA, Regs. 25120-25139, inclusive, shall be applicable except as otherwise provided in this regulation.

(b) Determination of Income.

(1) The income of a unitary business with operations in foreign countries shall be computed in the following manner:

(A) A profit and loss statement shall be prepared for each foreign branch or corporation in the currency in which the books of accounts of the branch or corporation are regularly maintained.

(B) Adjustments shall be made to the profit and loss statement to conform it to the accounting principles generally accepted in the United States for the preparation of such statements except as modified by this regulation.

(C) Adjustments shall be made to the profit and loss statement to conform it to the tax accounting standards required under Division 2 Part 11 of the Revenue and Taxation Code.

(D) The profit and loss statement of each branch or corporation, whether U.S. or foreign, shall be translated into the currency in which the parent company maintains its books and records in accordance with subsection (b)(4).

(E) Business and non-business income as determined under California law shall be identified and segregated. For general definition, rules and examples for determining business and non-business income, see Regulation 25120.

(F) Non-business income shall be allocated to a specific state pursuant to the provisions of Sections 25124 to 25127, inclusive of Division 2 Part 11 of the Revenue and Taxation Code.

(G) Business income shall be included in the combined report prepared for the unitary business and shall be apportioned on the basis of the appropriate formula for the business.

(H) Income from California sources shall be expressed in dollars in accordance with subsection (b)(4) and the taxes computed accordingly.

(2) In lieu of the procedures set forth in subsection (b)(1) and subject to the determination of the Franchise Tax Board that it reasonably reflects income, a unitary business with operations in a foreign country may determine its income on the basis of the consolidated profit and loss statement prepared for the related corporations of which the unitary business is a member which is prepared for filing with the Securities and Exchange Commission. If the business is not required to file with the Securities and Exchange Commission, the consolidated profit and loss statement prepared for reporting to shareholders and subject to review by an independent auditor may be used.

(A) Adjustments shall be made, if necessary, to:

(i) conform to the accounting principles generally accepted in the United States for the preparation of such statements, except as modified by this regulation;

(ii) conform to the tax accounting standards as required under Division 2 Part 11 of the California Revenue and Taxation Code; and

(iii) eliminate unrealized gain and losses resulting from the restatement or revaluation of assets or liabilities to reflect changes or fluctuations in currency values.

(B) Business and non-business income as determined under California law shall be identified and segregated. For definitions, rules and examples for determining business and non-business income, see generally Regulation 25120.

(C) Non-business income shall be allocated to specific states pursuant to the provisions of Sections 25124 to 25127, inclusive of the Revenue and Taxation Code.

(D) Business income shall be included in the combined report prepared for each unitary business and will be apportioned on the basis of the appropriate formula for each business.

(E) Income from California sources shall be expressed in dollars in accordance with subsection (b)(4) and the taxes computed accordingly.

(3) For purposes of subsections (b)(1)(B), (b)(1)(C) and (6)(2)(A), the following rules shall apply:

(A) Accounting adjustments to be made to conform profit and loss statements to those utilized in the United States–

(i) Include but are not limited to the following:

(I) Clear reflection of income. Any accounting practice designed for purposes other than the clear reflection on a current basis of income and expenses for the taxable year shall not be given effect. For example, an adjustment shall be required where an allocation is made to an arbitrary reserve out of current income.

(II) Physical assets, depreciation, etc. All physical assets, including inventory when reflected at cost, shall be taken into account at historical cost computed either for individual assets or groups of similar assets. The historical cost of such an asset shall not reflect any appreciation or depreciation in its value or in the relative value of the currency in which its cost was incurred. Depreciation, depletion, and amortization allowances shall be based on the historical cost of the underlying asset, and no effect shall be given to any such allowance determined on the basis of a factor other than historical cost.

(III) Valuation of assets and liabilities. Any accounting practice which results in the systematic undervaluation of assets or overvaluation of liabilities shall not be given effect, even though expressly permitted or required under foreign law, except to the extent allowable under subsection (b)(3)(B). For example, an adjustment shall be required where inventory is written down below market value.

(IV) Income equalization. Income and expense shall be taken into account without regard to equalization over more than one accounting period; and any equalization reserve or similar provision affecting income or expense shall not be given effect, even though expressly permitted or required under foreign law.

(ii) Currency gains or losses on closed transaction are includible, but no adjustments shall be made, or otherwise reflected, for unrealized gains or losses resulting from the restatement or revaluation of assets or liabilities to reflect changes or fluctuations in currency values. A closed transaction is one where any foreign exchange position taken by a corporation has been terminated by exchanging the foreign currency for the currency in which the individual corporation maintains its books and records and normally conducts its business affairs. In the case of a borrowing in a foreign currency, the transaction shall not be deemed closed until repayment is made.

(B) The tax accounting adjustments to be made shall include, but are not limited to, the following:

(i) Accounting methods. The method of accounting shall reflect the provisions of Section 24651 of the Revenue and Taxation Code and the regulation thereunder.

(ii) Inventories. Inventories shall be taken into account in accordance with the provisions of Sections 24701 through 24706 of the Revenue and Taxation Code and the regulations thereunder, except Regulation 24702-24706(b)(5).

(iii) Depreciation, depletion, and amortization. Depreciation, depletion and amortization are to be computed in accordance with California law.

(iv) Elections.

(I) Elections required to be made for purposes of determining income under Division 2 Part 11 of the Revenue and Taxation Code of all California reporting entities shall be made in accordance with applicable provisions of such law and the regulations adopted pursuant thereto.

(II) Elections required to be made for purposes of determining income under Division 2 Part 11 of the Revenue and Taxation Code for entities which are not subject to taxation by California but are required to be included in the combined report for the unitary business shall be made by agreement of all entities required to report to California in accordance with applicable provisions of such law and the regulations adopted pursuant thereto. If agreement cannot be reached, such income shall be reported on the basis of United States generally accepted accounting principles.

(C) No adjustment shall be required under subsections (b)(3)(A) and (b)(3(B) unless it is material. Whether an adjustment is material depends upon the facts and circumstances of the particular case, including the amount of the adjustment, its size relative to the general level of the corporation's total assets and annual profit or loss, the consistency with which the practice has been applied, and whether the item to which the adjustment relates is of a recurring or a non-recurring nature.

(4) For purposes of determining income, necessary translations shall be made at the following exchange rates:

(A) Depreciation, depletion, or amortization shall be translated at the appropriate exchange rate for the translation period in which the historical cost of the underlying asset was incurred.

(B) All other items shall be translated at either the end-of-year exchange rate or at the simple average exchange rate for the translation period. Income repatriated during the year shall be translated at the exchange rate at date of repatriation. It is presumed that the translation rate used in preparing the consolidated profit and loss statement for financial reporting purposes is proper absent a showing that some other method is appropriate.

A change from end-of-year rates or average rates may not be made without the permission of and on such conditions as the Franchise Tax Board may prescribe.

(c) Computation of Factors. In computing the formula factors, the following rules shall apply:

(1) Property Factor.

(A) Fixed assets shall be valued at original cost as defined in Reg. 25130(a) and translated at the exchange rate as of the date of acquisition.

(B) Rented property, capitalized at eight times its annual rental rate, shall be translated at the simple average of the beginning and end-of-year exchange rate.

(C) Inventories shall be valued at original cost and shall be translated at the exchange rate as of the date of acquisition.

(D) For purposes of calculating the property factor of financial corporations, financial assets are translated at the year-end rate and are defined as assets reflecting a fixed amount of currency, such as cash on hand, bank deposits, and loans and accounts receivable. Securities held, or reasonably expected to be held, for less than six months shall be translated at year-end rates. If a security is held, or reasonably expected to be held, for more than six months, it shall be translated at the appropriate exchange rate for the translation period in which the historical cost of the asset is determined.

(E) The property factor shall be computed in the currency of the parent company unless the taxpayer requests and the Franchise Tax Board determines that computing the factor in dollars or any other currency fairly reflects the taxpayer's activities in California.

(2) Payroll and Receipts Factors.

(A) Translation shall be made at the simple average of the beginning and end-of-year exchange rates unless there is a substantial fluctuation, as described in subsection (d)(2).

(B) Where the value of the foreign currency does fluctuate substantially, as described in subsection (d)(2) the exchange rate appropriate to that period shall be either (1) a simple average of the month-end rates, or (2) a weighted average taking into account the volume of transactions (reflected by the amount being translated) for the calendar months ending with or within that period.

(C) In computing the payroll and receipts factors, translation shall be made into the parent company's currency in order to properly determine the percentage factor to be used unless the taxpayer requests and the Franchise Tax Board determines that computing the factors in dollars or any other currency fairly reflects the taxpayer's activities in California.

(d) Exchange Rates.

(1) For purposes of preparing combined reports, exchange rates may be derived from any source which is demonstrated to the satisfaction of the Franchise Tax Board to reflect actual transactions conducted in a free market and involving representative amounts. In the absence of such demonstration, the exchange rates taken into account in computation of the earnings and profits of the foreign corporation shall be determined by reference to the free market rate set forth in the pertinent monthly issues of *International Financial Statistics* or successor publications of the International Monetary Fund.

(2) In general, the extent of fluctuation is substantial if the closing rate for any calendar month ending within the period varies by more than 10% from the closing rate for any preceding calendar month ending within the period.

(e) Application of Regulation.

(1) In computing the income and any of the factors required for a combined report, the Franchise Tax Board shall consider the effort and expense required to obtain the necessary information. In appropriate cases, such as when the necessary data cannot be developed from financial records maintained in the regular course of business, the Franchise Tax Board may accept reasonable approximations.

(2) A taxpayer may request an advance determination under subsections (b)(2), (b)(3)(C), (c)(1), (d)(1) or any other provision of this regulation by submitting a determination request to the Legal Division of the Franchise Tax Board. Such a determination shall be made on an individual basis and shall be limited to the particular facts or circumstances set forth in the determination request. The facts and circumstances upon which a determination is made remain subject to review. Failure to request or to obtain a favorable advance determination will not preclude consideration of requested variances in subsequent proceedings.

Note: Authority cited: Section 26422, Revenue and Taxation Code.
Reference: Section 25137, Revenue and Taxation Code.

(Applicable for income years beginning after 31 December 1972; amended effective 27 March 1985.)

THE PERIPATETIC ALIEN: HIS/HER TAX PROBLEMS IN THE UNITED STATES AND ABROAD

By Nathan Boidman

SYNOPSIS

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PART A – OVERVIEW OF TAX ISSUES FOR THE PERIPATETIC ALIEN

I. INTRODUCTION

Individuals who migrate from one country to another or who spend extensive periods of time in a foreign country as tourist, vacationer or visiting executive or businessman may be subject to a variety of issues arising under taxation law relating to income, estates, gifts or wealth. Countries such as Canada, the United States and the United Kingdom may impose substantial taxes on individuals who either become generally subject to their taxing jurisdiction by reason of residence, domicile (and in the case of the United States, citizenship) or other criterion of a similar nature or where such individual derives income from sources within such jurisdictions.

The taxation issues for the peripatetic alien may arise in a variety of circumstances. Those who originate from high rate jurisdictions may seek refuge from taxation by migrating to so-called tax havens. Or they may wish to establish and maintain ongoing presence in such high tax jurisdictions for personal or business purposes (hopefully) without engaging liability to taxes arising under their laws. Whatever the circumstances such individuals and their advisors must assess a variety of taxation rules to establish the nature and extent of the tax burden which may be engaged as a consequence of such activities.

The general pattern and scheme of taxation is often quite similar in the various countries which may be relevant, i.e. taxation of worldwide income or assets of "residents" or "domiciliaries", but the specific rules may vary widely. As well such rules may often undergo substantial or even radical change, thereby exacerbating the tax issues involved. Perhaps the best example of such change are the recently enacted rules for establishing residence for income tax purposes under the Internal Revenue Code, discussed below.

The purpose of this article is twofold: (1) examine some of the more important features and specifics of the manner in which the peripatetic alien may be taxed in various countries such as Canada, the U.S. and certain European jurisdictions and (2) review the general impact of the U.S. residence rules on such individuals in general and Canadians in particular. While it is clearly beyond the scope of an article of this type to examine the topic exhaustively, the following material should serve to provide a framework in which particular situations may be assessed in order to identify effective techniques and approaches for planning the tax affairs of the peripatetic alien.

II. ISSUES IN THE COUNTRY OF EMIGRATION

Analysis of the issues facing the peripatetic alien tend to focus on the country to which he immigrates or in which he sojourns. Issues, however, can also arise in the home country, the country of emigration.

[1] Terminating resident status

Liability to tax generally depends on status as a "resident" or "non-resident". A resident generally is taxed on worldwide income.[1] A non-resident generally is taxed only on certain source or effectively connected income.[2]

Resident status generally is determined for the departing or emigrating individual under the same rules applicable to the incoming or immigrating individual. See discussion in III[2]. There, however, are differences. Where, as was the case in the U.S. prior to the enactment of IRC S.7701(b),[3] residence is determined on a facts and circumstances basis, the standard imposed by a court may be more stringent for the departing resident than the incoming individual. In a recent Canadian case, a migrant worker in the resource industry who effectively moved to Ireland for a three-year period and returned only occasionally to Canada for brief visits was held to be a Canadian resident throughout.[4] But a 1985 U.K. decision[5] reflects the opposite tendency. The Chancery Division found that the taxpayer (Dave Clark of the singing group "The Dave Clark Five") had successfully terminated U.K. residence by arranging total physical absence from the U.K. during the period 3 April 1978 to 2 May 1979. The sole purpose of the arrangement was to receive a substantial item of income during that period of absence without liability to U.K. tax.

Some countries such as Canada take the view that residence must subsist *somewhere* and residence status may continue until firm ties are established elsewhere.[6] The rule was opposite in the U.S., prior to 1985.[7] In the Netherlands a Dutch individual who "was technically not liable to tax in any one jurisdiction but, falling victim to the maxim that 'one must be taxable somewhere', was liable to tax in the Netherlands".[8]

In Sweden, there is the "three-year rule", pursuant to which "Swedish citizens are deemed resident in Swe-

1. Section 2(1) of the Income Tax Act (of Canada), Revised Statutes of Canada, 1952, chapter 148, as amended since, particularly by chapter 63 of the Statutes of Canada, 1970-71-72 ("the Canadian Act"). Section 1 of the Internal Revenue Code, 1954, as amended ("IRC").
2. S.2(3), Canadian Act; IRC S.871.
3. S.138(a) of the Tax Reform Act of 1984, a division of the Deficit Reduction Act of 1984, P.L 98-369. (The new law was originally introduced as part (S.503) of the "Tax Simplification and Improvement Act of 1983", (H.R. 3475) introduced in the House of Representatives on 30 June 1983.)
4. *Roy v. M.N.R.*, 83 DTC 576. See, generally, Boidman, Chopin and Granwell, *Tax Effects for Canadians of the New U.S. Code and Treaty Residency Rules,* TMIJ, Vol. 14, No. 5, 144 (May 1985) and Vol. 14, No. 6, 183 (June 1985).
5. *Reed (Inspector of Taxes) v. Clark,* STC 323 [1985].
6. *Thomson v. M.N.R.*, 42 DTC 812, and *Reicker v. M.N.R.*, 71 DTC 232.
7. Boidman, Chopin and Granwell, supra note 4, at 161.
8. Van der Beek, *There is Always a Place Where You Can Be Taxed,* International Tax Report, August 1985, p.10.

den for tax purposes until they can prove that all important ties with Sweden have been broken".[9]

In the U.K. it seems that the Inland Revenue will not classify an emigrant as a non-resident during the first four years following departure with a return to the U.K. for more than three months in any one year.[10] "In general, for any given year, an individual will be resident in the U.K. if . . . he or she pays regular visits to the U.K. averaging three months per year over four consecutive years even though he or she maintains no regular place of abode".[11]

In some countries continued maintenance of a home may be determinative. U.K. residence is maintained (or arises) where "a place of abode is maintained in the U.K. and (the person) visits the U.K. for any period . . . except in the course of incidental duties of a wholly foreign-based employment (S.50 ICTA, 1970)".[12] Belgium has rejected such rule.[13] In Canada the maintenance of a home is only one of several factors which a court may take into account in determining whether an emigrant has successfully terminated Canadian residence.[14]

[2] Departure tax

Departure, i.e. termination of residence, may constitute a taxable event.

Canada imposes a tax on unrealized appreciation in respect of capital property.[15] Under this rule a person is deemed to dispose of his "capital property"[16] at the date upon which he ceases to be a resident of Canada for an amount equal to the fair market of the property at that time. Liability to income tax arises, which generally requires an inclusion in regular income of one half of the gross capital gain realized. This rule however does not apply to certain Canadian-based assets, "taxable Canadian property", inasmuch as non-residents are liable to Canadian tax in respect of gains realized from the disposition thereof.[17] This rule would apply, for example, to United States real estate owned by a Canadian at the time of departure. The emigrating Canadian may, however, elect to defer the tax but remain liable to Canadian tax in respect of a future disposition, in respect of both the unrealized appreciation to the date of departure and that which arises thereafter.

Few, if any other, countries tax in such fashion. See also discussion below respecting the circumstances under the new Code rules pursuant to which a former (alien) resident may be subject to tax in respect of certain U.S.-source income or gains after terminating U.S. residence.[18]

[3] Post-departure taxation of income

[a] General

There may be special rules for taxing source income of a non-resident who formerly resided in the country.

Canada may tax salary paid by a Canadian company to a former resident in respect of services rendered *out* of Canada.[19] This is an anti-avoidance rule intended to prevent individuals from deferring and ultimately avoiding Canadian tax on Canadian-source employment income by arranging to receive the amounts in the guise of payments for services rendered outside of Canada after departure. The bona fides of the arrangements are effectively evaluated by a series of exceptions designed to objectively determine whether payments are factually referable to post-departure services. These include payments made to a person who is subject to tax in his new jurisdiction residence or in respect of services rendered in connection with negotiations of contracts or in relation to a business carried on by the Canadian employer (or its foreign subsidiary) outside of Canada.[20] Similar results arise in the Netherlands.[21]

The U.S. may tax U.S.-source gain of an alien who has terminated U.S. residence. Under IRC S.7701(9) an alien who was resident in the U.S. for three consecutive years and then re-establishes U.S. residence within a three-year period subsequent to departure will be liable to U.S. tax in respect of certain income or gains related to certain U.S. property under rules comparable to those applicable to U.S. citizens who expatriate for tax purposes.[22]

Germany has the notion of "extended limited taxation", under section 2-5 of the foreign tax law (Aussensteuergesetz), which may affect ongoing liability to income tax, net wealth tax and inheritance and gift tax for a ten-year period. These rules apply to individuals who take up residence in a tax haven or apparently have no residence at all and have been subject to unlimited tax liability in Germany for at least five of the ten years prior to emigration, had German citizen-

9. Sundqvist, *Cahiers de droit fiscal international,* Volume LXXa (infra, note 49) (National Report – Sweden), p.614.
10. M. Roy Saunders, *Principles of Tax Planning,* Finax Publications (London, 1978).
11. Kieran and Rabin, *Is the United Kingdom Still a Tax-Haven for Foreigners?,* 66 Taxes International, April 1965, p.18 (at 18). See *Levine v. IRC,* 13 TC 486; *IRC v. Lysacht,* 13 TC 511; Board of Inland Revenue, publication IR20, para. 21.
12. Kieran and Rabin, ibid.
13. *Residence-Rental of Apartment in Belgium,* 24 European Taxation 5 (1984), p.150.
14. See Boidman and Ducharme, *Taxation in Canada – Implications for Foreign Investment,* Kluwer (the Netherlands) 1985, Chapter IV.
15. S.48, Canadian Act. See Boidman and Ducharme, op. cit., Chapter XXX, and Sherman and Sherman, *Migration – Canada,* Kluwer (the Netherlands) 1985, Chapter 12.
16. S.54(b), Canadian Act.
17. S.2(3)(c), 115(1)(a)(iii) and 115(1)(b), Canadian Act.
18. IRC S.7701(9).
19. S.115(1)(a)(v) and (2), Canadian Act.
20. S.115(2)(d), (e) and (f), Canadian Act.
21. *Golden Handshake – Severance Payment by a Dutch Company to a Resident in Spain is Taxable in the Netherlands,* 23 European Taxation 12 (1983), p.403.
22. IRC S.877. See Karp, *Definition of Citizenship, Residence and Domicile for U.S. Income, Gift and Estate Tax Purposes,* 43rd Annual NYU Institute on Federal Taxation, Ch. 13; LeBeau, *Abandoning U.S. Residence or Citizenship,* 49 Taxes International, November 1983, p.65; and Hoffman, *Expatriation as a Method of Tax Avoidance: Is it Possible? Is It Feasible?,* Taxes, September 1984, p.640.

ship for at least five of those years, and continue to maintain substantial economic interests in Germany. In such circumstances the taxpayer is liable for full German tax in respect of certain German-source income or properties as defined.[23]

Canada may tax a post-departure gain in respect of non-Canadian property realized by a former Canadian, who has elected to defer the departure tax (see II[2]).[24] In such circumstances a unilateral credit will be granted against such Canadian taxation in respect of taxes paid to a foreign jurisdiction.[25]

[b] Departing executives – incentives

Incentive exemptions or relief may be granted to departing executives where ordinary residency status (or, in the case of the U.S., citizenship status) does not terminate.

Canada grants an 80% tax credit on certain foreign-source employment income involving Canadian employers.[26] This rule which is intended to provide an incentive to Canadian companies engaged in construction, resources and other prescribed industries to expand abroad would limit such relief to the first $100,000 of employment income derived by executives and other personnel who retain their Canadian resident status during their foreign postings, thereby operating in a fashion not totally dissimilar to the rules arising under IRC S.911 for U.S. citizens and residents living abroad.[27] The Province of Quebec which uniquely, among the Canadian provinces, administers its own tax statute for individuals provides similar incentives.

Other countries such as the Netherlands, Germany, the U.K., Belgium and France also exempt in whole or in part foreign-source employment income of residents who are posted abroad. In the Netherlands, new incentives have recently been adopted as a response to circuitous stratagems, involving foreign personal holding companies previously used by Dutch individuals working in low taxing jurisdictions, particularly in the Middle East.[28]

The U.K. exempts a non-domiciled resident from tax in respect of foreign employment income, derived from a foreign employer and not remitted to the U.K.[29] Changes under the Finance Act 1984 make it desirable to establish separate contracts of employment for U.K. and non-U.K.-source employment. However, such strategies aren't effective where a U.K. employer is involved.

[4] Considerations during the transitional period

Liability to tax on income accrued prior to departure, but realized subsequent thereto differs according to particular facts and circumstances. Tax on cash basis items, e.g. salary or certain investment income sourced out of country of emigration, may escape tax.[30] Trust income accrued after departure but in such year, may also not be taxed.[31] Such pattern is seen in many countries.[32]

Use of losses or reserves may be affected by a change of residence status. A person who emigrates from Canada is not entitled to capital gain reserves in the year of emigration or the prior year.[33] Such results will vary from country to country.[34] Results may be different for a person giving up U.S. residence (assuming he is not a U.S. citizen). Leaving aside the particular rules affecting instalment sales of U.S. real property interest,[35] a non-resident, whether formerly resident in the U.S. or not, who is entitled to defer recognizing income pursuant to IRC S.453, may be exempt in whole or in part from U.S. tax upon a subsequent collection of the instalment obligation, where the receipt thereof in a subsequent year is not effectively connected to a U.S. trade or business. Prior to FIRPTA (IRC S.897) such arrangements often provided the basis for foreign investors to avoid U.S. tax in respect of gains derived from the disposition of interests in U.S. real estate.

[5] Taxation of ongoing investments in the country of emigration

Taxation of ongoing investments in the country of emigration may vary according to the investment holding structure. Such structure may be more easily reorganized prior to departure. A non-resident of Canada, unlike a resident, cannot transfer Canadian real estate to a (Canadian) holding corporation on a "rollover" basis.[36] Accordingly, certain advantages of owning such property through a Canadian corporation (e.g. more flexibility in utilizing loss carry-forwards) may be precluded if the property is not transferred prior to terminating residence.

A non-resident alien cannot exchange a United States real property interest for foreign real estate on a non-

23. See Mittendorf, *Federal Republic of Germany: Foreign Tax Law: Aussensteuergesetz II: Change of Residence to Low-Tax Countries,* 14 European Taxation 10 (1974) at 346; and *Foreign Tax Law – Extended Limited Tax Liability (Decision of the Supreme Court (Bundesfinanzhof) of 28 March 1984),* 25 European Taxation 4 (1985) at 117.
24. S.48, 115(1)(a)(iii) and 115(1)(b), Canadian Act.
25. S.126(2.2), Canadian Act.
26. S.122.3, Canadian Act.
27. Gillespie, *Relief for Employees Working Abroad: 1983 Federal Overseas Employment Tax Credit and 1983 Quebec Overseas Employment Deduction,* 1983 Conference Report, Report of Proceedings of the 35th Tax Conference, Canadian Tax Foundation, p.443.
28. Van Haaren, *End of the "Cyprus Route" for Dutch Employees Assigned Abroad,* Strategy in International Taxation, Vol. I No. 2 (1985), p.122. This article also notes similar legislation in Germany, the U.K., Belgium, France and the U.S., in respect of citizens under section 911. See also Van der Beek, *The Dutch Cyprus Route Remains Open – For Some,* International Tax Report, September 1985, p.9.
29. S.181(1) ICTA 1970, Sch. 2, Para. 4, Finance Act, 1974. See Kieran and Rabin, supra note 11.
30. S.2, 3, 115 and 212, Canadian Act.
31. *Furstenberg,* infra note 95, and *Petschek,* infra note 92.
32. See, generally, discussion in III[4]. See also Sherman and Sherman, supra note 15, at Chapter 17.
33. S.40(2)(a), Canadian Act.
34. See Albregtse, *Immigration and Existing Losses,* Intertax, 1984/9, p.337.
35. IRC S.897 et al.
36. S.85(1), Canadian Act.

recognition basis.[37] Thus, an alien who is planning to terminate U.S. residence may be advised to exchange a U.S. real property interest for such an interest situate in another country prior to departure. Although there would be a carry-over in basis from the USRPI to the foreign real estate interests for U.S. tax purposes, post-departure disposition of the foreign real estate would not normally be subject to U.S. taxation.

[6] Other matters to consider

In most countries termination of residence for income tax purposes may not affect ongoing residence (domicile) for estate, inheritance and gift tax purposes. For example, IRC S.7701(b) applies only for income tax purposes. See III[10]. Canada does not impose such taxes but does tax a resident (for income tax purposes) on unrealized appreciation of certain property at death or in respect of inter vivos gifts.[38] This means that a Canadian who terminates residence for tax purposes but remains a domiciliary will not generally be liable to Canadian taxation at death, although the deemed disposition rules for income tax purposes would apply to "taxable Canadian property"[39] or property which the departing resident has elected to be so treated in order to avoid the departure tax described earlier.[40]

Termination of residence may affect family members of controlled corporations. In Canada, "Canadian-controlled private corporation" status may be lost, resulting in higher corporate taxation.[41] A corporation is a CCPC where not more than 50% of its outstanding voting shares are owned directly or indirectly by non-residents or public Canadian corporations.[42] Such corporations generally are entitled to a 21 percentage point reduction in the standard 46% corporate rate of tax otherwise applicable in respect of up to $200,000 of income derived from active businesses carried on in Canada. In the U.S., departure may eliminate Foreign Personal Holding Company (FPHC) status for unrelated U.S. persons.[43]

Other considerations include travel, currency and asset transfer restrictions, ongoing reporting requirements, and the effects if there is a return to the country.

III. ISSUES IN THE COUNTRY OF SOJOURNING OR IMMIGRATION

[1] Overview

Precise issues for the peripatetic alien in the country of sojourning or immigration depend upon whether he becomes resident for tax purposes in such country. See II[1] and III[2]. Such determination may be affected by visa status, the purposes of his visits or sojourn, the length or frequency thereof and related factors. Implications may arise under income tax law, those relating to estate, inheritance or gift taxes, and, in some European countries, tax on capital or wealth.

[2] Residence for income tax purposes

Residence in most countries is determined on a facts and circumstances basis, sometimes augmented by exceptional rules of a more mechanical or technical nature. Exceptionally, the new IRC S.7701(b) rules (discussed in Part B) are primarily and substantially based on mechanical, objectively determinable factors.

In Canada, a tax resident is a person who is "ordinarily resident".[44] Such status turns on an overall assessment of "physical presence, intentions, family ties, commercial or other business ties, legal status, existence of a physical home, evaluated in the context of an individual's past facts and circumstances".[45] The case-made law has largely been developed in respect of departing residents and, accordingly, must be tempered in application to the determination of the status of an incoming person.[46] Canada also taxes a person as resident for any year during which he "sojourns" in Canada for 183 days or longer.[47] For a similar rule in the U.K., see S.51 ICTA, 1970. There are also special rules for certain Canadian Government employees etc.[48]

Such pattern is seen generally in other countries. "Residence or domicile in relation to particular instances often turns out to be a vague and complex concept based partly on the physical presence and partly on the intentions of the potential taxpayer. This is well recognized and it is presumably because of it that many countries use such terms in their tax law without defining them, or if they do define them, define them in a way which leaves much to the interpretation of the administration and the law courts."[49]

37. IRC S.897(e)(1) cf. IRC S.1031.
38. S.69(1)(b) and 70(5), Canadian Act.
39. Supra, note 17.
40. See II[2]. See, generally, Schwarz, *Emigration Rules, Canada*, World Tax Report (Financial Times), January 1983, p.9.
41. S.125, Canadian Act.
42. Under S.89(1)(g) of the Canadian Act a "public corporation" is one whose shares are listed on a recognized Canadian stock exchange or which meets certain other prescribed rules.
43. IRC S.551 et seq.
44. S.250(3), Canadian Act.
45. Boidman, Chopin and Granwell, supra note 4 at p.145.
46. For example, the decision in *Roy*, supra note 4, would not arise in circumstances where the precise same activities in Canada during the years in question were carried out by a person who previously was not a long-term Canadian resident.
47. S.250(1)(a), Canadian Act. It should be noted that the Canadian rules do not stipulate whether a day for these purposes includes part-day or requires an aggregation of 24-hour periods. The latter is the better view of the matter.
48. S.250(1)(b)-(f), Canadian Act. See Boidman and Ducharme, supra note 14, Chapter IV, and Sherman and Sherman, supra note 15.
49. Phillips and Collings, General Report, *The Assessment and Collection of Tax from Non-Residents*, Cahiers de droit fiscal international, Vol. LXXa, IFA, London 1985 (Kluwer), p.15 at p.20. This volume contains national reports from 27 countries. For an example of a country which, like the U.S., utilizes mechanical tests, see India: Chandra (National Report – India), p.445; see also Italy, Guidice (National Report – Italy), p. 465. See also II[1]. The U.S., of course, has recognized this problem, by enacting IRC S.7701(b), supra note 3. The reason for the new law is explained in the House Ways & Means Committee Report as follows: "The Committee believes that the tax law should provide a more objective definition of residence for income tax purposes. The Committee believes that the pre-

[3] Scope of taxation applicable to tax residents

[a] General

Most countries subject an alien who is "resident" therein to the same tax regime applicable to citizens or nationals who are also resident therein. Generally, this entails liability to tax on worldwide income. See II[1]. Certain exceptional rules should be noted.

There are only a few countries, notably the U.S., which tax citizens who are not resident therein on worldwide income.[50] "The Philippines also taxes its citizens, wherever resident, but the tax burden is small – a maximum of 3% of their adjusted gross foreign income".[51]

The U.K. taxes an alien who is resident (or "ordinarily resident") but not domiciled only on certain income which is derived from the U.K. or "remitted" from abroad thereto.[52] This regime creates tax haven facilities for the wealthy peripatetic alien. See discussion in III[9].

A Brazilian is treated as a non-resident when "absent for more than twelve months" as are "residents abroad who remain in Brazil for less than twelve months".[53]

"Hong Kong does not seek to assess tax by reference to such concepts as residence or fiscal domicile. . .. The Inland Revenue Ordinance . . . (is) . . . designed only to charge income and profits which arise or derive from the Territory".[54]

[b] Incoming executives – incentives

Some countries restrict tax liability of incoming executives.

Foreign employees assigned to Dutch subsidiaries or branches for a period not exceeding five years may be exempt from such tax up to 35% of their earnings and, in addition, are treated as non-residents generally for Dutch tax purposes.[55]

Belgium granted new incentives in 1983.[56] This, together with the 1982 "T" zone incentives for foreign-owned investment,[57] provides an attractive tax climate for foreign-based multinationals and their personnel.

The U.K. tightened up its incentives in 1984 but tax reduction opportunities remain.[58]

[c] Other considerations

Certain groups entail additional considerations. For example, athletes and performing artists may be subject to the special loan-out rulings in the U.S. and back-up anti-avoidance provisions of treaties. For example, Article XVI of the 1980 Canada–U.S. Income Tax Convention[59] serves to tax substantially all income earned by cross-border athletes and entertainers excluding application of the exemptive rules for business profits (Article VII) and independent services (Article XIV).[60]

The pattern for taxing residents is similar in most coun-

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sent law does not provide adequate guidance with respect to residence status. The Committee understands that an objective definition may allow some aliens who should be taxable as residents to avoid resident status, and would impose resident status on some aliens who are not residents, under the current rules. On balance, however, the Committee finds that the certainty that the Bill's objective definition provides outweighs other considerations." Source: H.R. Rep. No. 432 (Part II) 98th Cong. 2d Sess. at 1523.

50. IRC S.1.

51. Sherman and Sherman, *Moving to Canada: A Checklist for Immigrants*, CA Magazine, January 1985, p.60.

52. S.108, 122 and 181 ICTA, 1970, with respect to income (see also II[3][b] and III[9]) and S.14, CGTA, 1979 with respect to capital gains. See, generally, Kieran and Rabin, supra note 11.

53. Pinto (National Report – Brazil), supra note 49, p.299 at p.301.

54. Stolerman (National Report – Hong Kong), supra note 49, p.433 at p.435.

55. See Tomsett, *Incentives for Foreign Investors in Major EEC Countries: The Netherlands*, TPIR, Vol. 11, No. 3 (March 1984), p.3. See also van Raad, *Foreign Employees Working Temporarily in the Netherlands*, TPIR, Vol. 12, No. 9 (September 1985), p.28.

56. See *New Belgium Tax Rules Benefit Expatriate Executives*, International Tax Alert, January 1983, p.1; *Belgium – Administrative Circular on Taxation of Expatriate Executives*, TPIR, Vol. 10, No. 11 (Nov. 1983), p.14.;*Belgium: Taxation of Foreign Executives*, Intertax 1984/5, p.182; see also *EEC: Tax Relief for Cross-Frontier and Migrant Workers*, Intertax 1984/4, p.174.

57. See Okelinx, *Simplifying Incentives*, World Tax Report (Financial Times), November 1982, p.13; Okelinx, *Belgium – Zone Incentives*, World Tax Report (Financial Times), December 1982, p.10; Lebrun, *Belgium – Supplementary Depreciation*, TMIJ, Vol. 82, No. 7 (July 1982), p.30; and Lebrun, *Belgium – Amendments to the Income Tax Act – Tax-Free Zones*, TMIJ, Vol. 82, No. 10 (October 1982), p.25.

58. See Goldsworth, *European Study Conferences: "Advance Tax-Planning for Non-Domiciled Persons"*, 54 Taxes International (April 1984), p.76. See also II[3][b].

59. *Convention between the United States of America and Canada with respect to Taxes on Income and on Capital*, P-H Federal Taxes, Tax Treaties I, p.22,030:

"Article XVI. ARTISTES AND ATHLETES

1. Notwithstanding the provisions of Articles XIV (Independent Personal Services) and XV (Dependent Personal Services), income derived by a resident of a Contracting State as an entertainer, such as a theatre, motion picture, radio or television artiste, or a musician, or as an athlete, from his personal activities as such exercised in the other Contracting State, may be taxed in that other State, except where the amount of the gross receipts derived by such entertainer or athlete, including expenses reimbursed to him or borne on his behalf, from such activities do not exceed fifteen thousand dollars ($15,000) in the currency of that other State for the calendar year concerned.

2. Where income in respect of personal activities exercised by an entertainer or an athlete in his capacity as such accrues not to the entertainer or athlete but to another person, that income may, notwithstanding the provisions of Articles VII (Business Profits), XIV (Independent Personal Services) and XV (Dependent Personal Services), be taxed in the Contracting State in which the activities of the entertainer or athlete are exercised. For the purposes of the preceding sentence, income of an entertainer or athlete shall be deemed not to accrue to another person if it is established that neither the entertainer or athlete, nor persons related thereto, participate directly or indirectly in the profits of such other person in any manner, including the receipt of deferred remuneration, bonuses, fees, dividends, partnership distributions or other distributions.

3. The provisions of paragraphs 1 and 2 shall not apply to the income of:
(a) An athlete in respect of his activities as an employer of a team which participates in a league with regularly scheduled games in both Contracting States, or
(b) A team described in subparagraph (a).

4. Notwithstanding the provisions of Articles XIV (Independent Personal Services) and XV (Dependent Personal Services) an amount paid by a resident of a Contracting State to a resident of the other Contracting State as an inducement to sign an agreement relating to the performance of the services of an athlete (other than an amount referred to in paragraph 1 of Article XV (Dependent Personal Services) may be taxed in the first-mentioned State, but the tax so charged shall not exceed 15 percent of the gross amount of such payment."

60. See Histrop, *Taxation of Canadian Resident Athletes and Artists Per-*

tries. The specific rules for inclusions and deductions, applicable rates of tax and ancillary considerations may, however, vary substantially from country to country.[61]

[4] Pre-arrival planning

[a] General

Countries such as the U.S. and Canada tax worldwide income of an alien who becomes a tax resident to the extent realized or recognized under its domestic law after residence has commenced notwithstanding that such income has accrued or arisen, in the economic sense, prior thereto.[62] In the U.K. such part-year convention is extra-statutory.[63]

Such rules apply particularly to cash basis-type items of income: e.g. salary, portfolio income, and pensions etc. ([c] below). As a general matter, planning prior to arrival in respect of the foregoing and other areas may result in significant tax reduction once residence has been established. Some areas to consider are discussed next.

[b] Basis in assets

The effects respecting pre-arrival appreciation in assets may vary.

Canada, uniquely, grants an adjustment in basis in capital property, to fair market value at date residency commences, thereby effectively exempting appreciation of value arising prior to the establishment of Canadian residence.[64] This rule also means that decline in value prior to arrival but covered thereafter and realized in a post-arrival disposition would be subject to Canadian tax. In the result, immigrants need not accelerate dispositions of appreciated property but may be advised to consider transferring their depreciated property to family members who are not in Canada and perhaps foreign corporations or trusts prior to taking up Canadian residence. In the latter context see section [e] below. In Canada capital property normally comprises assets held for long-term investment but, unlike the U.S., often does not include undeveloped land even though held passively without any organized selling activities. Incoming individuals owning such land would, therefore, consider disposing of same (or transferring same to related entities such as a corporation or trust[65]) prior to arrival.

A person immigrating to the U.S. may have difficulty in reorganizing assets so as to step-up basis. In particular, (unlike Canada) non-recognition and basis carryover apply automatically under IRC S.351.[66] Pre-arrival step-up procedures may be more feasible for a person taking up residence (and domicile) in the U.K.[67]

The issue is of particular concern where the property could be disposed of without tax in the country of emigration. For example, a Canadian can often sell a personal residence without Canadian tax.[68] In the case of a move by a Canadian to the U.S. the problem is substantially eliminated by a special treaty rule under Article XIII(6) of the 1980 Canada–U.S. Income Tax Convention.[69]

[c] Pensions and annuities

Pension, annuity and similar arrangements may be particularly troublesome. An incoming Canadian is taxable on post-arrival receipt of pension rights accrued prior to arrival.[70] Moreover, post-arrival contributions to foreign pension plans are generally not deductible.[71] In the U.S. basis may be recognized in some pension arrangements effected prior to arrival.[72] This applies to annuity or life policies, even where premiums were tax-deductible in the country of emigration.[73] However, accrued gain in such policies does not constitute basis.[74]

Bilateral pension and social security agreement ("totalisation agreements") do not generally deal with taxation issues per se. See, for example, the United Kingdom–United States Social Security Agreement dated 13 February 1984, the primary objective of which is to eliminate social security contributions being paid to both the U.S. and the U.K. by individuals who are working in both countries. The United States has similar agreements with six other countries such as Canada (brought into force in August 1984).[75]

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forming in the United States, Canadian Tax Journal, Vol. 32, No. 6 (November-December 1984), p.1060. See also *Stemkowski,* 690 F. 2d 40, *aff'g* Rev'g and Rem'g in part, 76 TC 252 (1981) (Harwood, *Recent CA-2 Decision Focuses on Computing U.S. Source Income for Non-Resident Alien,* Journal of Taxation, May 1983, p.266); and Silbergleit, *Linseman v. Commissioner: U.S. Avenges Olympic Team's Loss to Canadian Hockey Players,* Canadian Tax Journal, Vol. 32, No. 3 (May-June 1984), p.616.

61. See, generally, *Difference in Tax Treatment between Local and Foreign Investors and Effects of International Treaties,* Cahiers de droit fiscal international, Vol. LXIIIb, IFA Congress, 1978 (Kluwer) and *An International Comparison – How They Stack Up in Taxes,* International Tax Report, January 1985, p.10. See also, *International Comparisons of Direct Tax on Employment Income,* a study prepared by the Board of Inland Revenue, November 1984, which compares the tax burden on personal income in the U.K., France, West Germany, Italy, Netherlands, Sweden, U.S. and Japan.
62. IRC S.7701(b)(2)(A). S.114, Canadian Act. Boidman, Chopin and Granwell, supra note 4, at p.146, 147, 155, 159 and 160.
63. A.II. Inland Revenue IR-1. See Kieran and Rabin, supra note 11, at p.19.
64. S.48(3), Canadian Act.
65. Under Canadian law such a transfer normally is deemed to comprise a disposition at fair market value with an associated step-up in basis. See S.69, Canadian Act. This is so even in the case of a transfer to a controlled corporation inasmuch as the Canadian rollover (non-recognition) rule applicable in such cases, pursuant to section 85 of the Canadian Act, requires an election in the absence of which section 69 recognition treatment applies. See Boidman and Ducharme, supra note 14 at Chapter X.
66. See Chopin, Granwell and Povell, infra note 87, at 244 et seq.
67. S.85, CGTA, 1979.
68. S.40(2)(b), Canadian Act.
69. Supra note 59. See Bernstein and Hanson, *A Guide for the Canadian Resident Departing to the U.S.,* 81-10 TMIJ 3 (October 1981), and Middleton, *Tax Implications of Departure from Canada",* CA Magazine, July 1983, p.44.
70. S.56 and 60, Canadian Act.
71. S.8, Canadian Act. *Stelfox v. M.N.R.,* 85 DTC 100.
72. IRC S.72. LTR 5809084910A (8 September 1958).
73. IRC S.61 and 72. LTR 8251014 (13 September 1982).
74. LTR 8107032 (19 November 1980).
75. See James P. Klein, *International Benefits Planning,* The International Tax Journal, Vol. 11:3, at 229 (Summer 1985).

Lump-sum pension payments can be particularly troublesome because they are often not covered by a double tax treaty agreement. See for example Article XVIII of the 1980 Canada–U.S. Convention. In a recent decision the Lower Court of the Hague decided that a lump-sum payment out of a Dutch pension plan qualified for a treaty Article respecting pensions solely because that Article expanded the term "pensions" to include "other similar remuneration".[76]

[d] Signing bonuses

A signing bonus effectuated prior to arrival in the U.S. in respect of future services to be performed in the U.S. may be taxable under the Code.[77] Canada has a statutory rule to such effect.[78]

[e] Restructuring investments

Typically incoming aliens may seek to restructure investments, prior to establishing residence in countries such as the U.S. or Canada, to avoid foreign income attribution rules.

In Canada such attribution can arise under the Foreign Accrual Property Income system.[79] In general, a Canadian resident is taxable in respect of his share of the accumulating passive income of a controlled non-resident corporation.[80] It is important to note that these rules apply whether the non-resident corporation is formed before or after resident status is established. Similar rules apply to a non-resident trust.[81] However, there is an exclusion for such income of such trusts formed prior to or after arrival in respect of income earned during the first five years of residence.[82] As noted, pre-existing corporate arrangements are not so excluded.[83]

In the U.S. there are the rules governing controlled foreign corporations,[84] foreign personal holding companies[85] and grantor trusts.[86] An alien who becomes a U.S. resident generally is not exempt from the CFC or FPHC rules in respect of arrangements effectuated prior to arrival. It may be possible to defer or avoid tax by establishing trust arrangements prior to establishing residence for U.S. tax purposes.[87] Grantor trust (attribution of income) rules may not apply to a foreign trust with U.S. beneficiaries if it is created by an alien grantor prior to assuming U.S. residence.[88] Moreover, certain provisions, e.g. a borrowing power in favor of an alien non-resident, may eliminate all taxes for a U.S. beneficiary, including the special 6% interest charge on accumulation distributions from foreign trusts.[89]

Aliens must consider that a 35% excise tax may arise on a post-arrival transfer of appreciated property to a foreign corporation or other foreign entity.[90]

Such rules also apply in France, Germany, Japan and the U.K.[91]

[f] Other matters

It is suggested that, on the basis of the decision in *Estate of Petschek v. Commissioner*,[92] an alien who becomes a U.S. resident would only be taxed on the foreign-source income received by a trust after the change of status.[93] In such circumstances a trust should seek to accelerate receipt of income prior to the change of status or, where the trust is to receive an extraordinarily large amount of income, the change of status should be delayed until after it is received.[94] *Petschek* dealt with an expatriating U.S. citizen. See also *Furstenberg*[95] which, in somewhat different circumstances, follows the reasoning in *Petschek*.

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76. *Pensions – Taxation of Lump Sum Payment under the Dutch–French Treaty*, 25 European Taxation 2, (1985) p. 56. See also Van Der Landu, *Surrender of Pension Rights by Non-Residents*, Financial Times World Tax Report, August 1984, p. 10. For such issues in a country such as Portugal see Sayer, *Foreign Residents – Taxation of Pensions and Annuities Received from Abroad*, 24 European Taxation 5 (1984), p.165.
77. *Linseman v. Commissioner*, 82 TC No. 39 (1984). See Silbergleit, supra note 60.
78. S.115(2)(c.1) and (e), Canadian Act.
79. S.91-95, Canadian Act.
80. S.91 and 95(1)(a), Canadian Act. Section 91 requires that a Canadian resident shareholder of a "controlled foreign affiliate" include a share of "Foreign Accrual Property Income" as computed under section 95(1)(b) of the Act. FAPI generally includes passive investment or property income or that arising from the conduct of businesses other than "active businesses". A controlled foreign affiliate is defined by section 95(1)(a) as constituting a "foreign affiliate" which is controlled by the Canadian shareholder either alone or together with no more than four other unrelated Canadian residents or by a related group regardless of resident status thereof. Control for these purposes normally means the ownership of more than 50% of the voting shares of the corporation entitling the holders thereof to elect the board of directors. "Foreign affiliate" is defined by section 95(1)(d) and 95(4) as being a non-resident corporation in which the Canadian shareholder owns directly or indirectly 10% or more of any class of stock whether voting or non-voting.
81. S.94, Canadian Act. (See also new S.94.1, "Offshore Fund Rules".)
82. S.94(1)(b), Canadian Act.
83. See, generally, Boidman, *The Foreign Affiliate System: Canadian Taxation After 1982 – A Structured Overview;* CCH Canadian 1983; and Boidman, *Canada's Taxation of Foreign Affiliates – 1982 Revisions*, TMIJ 83-4, April 1983, p.18 (Part I), 83-5, May 1983, p. 17, (Part II), 83-8, August 1983, p. 14, (Part III), Vol. 13, No. 2, Feb. 1984, p.48 (Part IV).
84. IRC S.951.
85. IRC S.551.
86. IRC S.679.
87. IRC S.665-668, 671-677 and 679. See Chopin, Granwell and Povell, *Pre-Immigration Planning, Residence and Domicile, Issues After the Tax Reform Act of 1984*, [Residency and Domicile – Issues after the Tax Reform Act of 1984 (Langer)] Practising Law Institute, 1985 (Real Estate Law and Practice Course Handbook, Series No. 224, J4-3565) p. 173, at p.238 et seq; Wyckoff, *Tax Planning for the Alien Resident for U.S. Income Tax But Not Domiciled in the U.S. For Estate and Gift Taxes*, (PLI, supra) p.261 at 279; Wyckoff, *U.S. Taxation of Foreign Trusts: U.S. and Non-U.S. Beneficiaries*, U.S. Taxation of International Operations, Prentice-Hall, paragraph 6014 (page 6271); Wyckoff, *U.S. Taxation of Foreign Trusts and U.S. and Non-U.S. Trust Grantors*, U.S. Taxation of International Operations, Prentice-Hall, paragraph 6013 (page 6241).
88. IRC S.679. Wyckoff, supra at 6247.
89. IRC S.668(a).
90. IRC S.1491. See also IRC S.367.
91. See Arnold, *The Taxation of Controlled-Foreign-Corporations*, 66 Taxes International, April 1985, p.3 which compares such regimes in Canada, France, Germany, Japan, U.K. and U.S.
92. 81 TC 160 (1983), aff'd 738 F.2d 67 (2d. Cir. 1984).
93. See Smith, *Estate of Petschek v. Commissioner: Emigrating and Immigrating Trust Beneficiaries*, Canadian Tax Journal, Vol. 32, No. 3 (May-June 1984), p.622.
94. IRC Reg. S.1.1871-13.
95. 83 TC 755 (1984). Smith, *Furstenberg v. Commissioner: Emigrating and Immigrating Trust Beneficiaries Revisited*, Canadian Tax Journal, Vol. 33, No. 3 (May-June 1985), p.624.

The effects of a community of property marital regime on liability vary in different countries. Prior to the 1984 Tax Reform Act an alien non-resident could effectively split income for purposes relevant to U.S. tax.[96] The 1984 Tax Reform Act amends section 879 to eliminate such advantage. In Canada community income is normally allocated to one consort or the other and not split between them.[97]

The taxation of alimony and related payments or receipts by the peripatetic alien may vary and in some cases advance planning may minimize tax effects.[98]

[5] Special considerations respecting real estate

An alien non-resident often structures foreign investment in foreign real estate through a corporation formed outside the country in which the realty is situate. This can, inter alia, provide exemption from inheritance taxes.[99] If the alien immigrates to the country where the realty is situate, it may be desirable to eliminate the intermediary holding corporation. This cannot always be accomplished on a tax-free basis.

If the country involved is the U.S., the alien should be able to contribute the holding company stock to a U.S. corporation and liquidate the former without recognition of gain.[100]

If the country involved is Canada, any liquidation of a non-Canadian corporation will be taxable to such corporation.[101] The non-recognition rules for corporate liquidations only apply to a "Canadian Corporation".[102] An indirect "butterfly" procedure may be possible but should not be attempted without a ruling.[103]

Japan, Italy and Holland, among other countries, would also tax a distribution of real estate by a domestic corporation.[104]

Recent developments in the U.K. may militate against owning a U.K. residence through a non-U.K. corporation. A 6% imputed rent benefit may be imposed.[105]

[6] Special considerations respecting closely held family corporations

If an alien who has an interest in a holding and/or operating corporation becomes a U.S. resident, the CFC and FPHC rules (III[4][e]) may apply. Providing a FPHC does not otherwise earn tainted (FPHC) income, same country dividends from a related operating company no longer are subject to attribution.[106] The 1984 Tax Reform Act also ameliorates the effects of the stock ownership attribution rules for determining FPHC status on unrelated third party U.S. taxpayers, who are shareholders of such corporations.[107]

Some countries may treat a foreign corporation owned by an incoming alien as resident and subject to worldwide taxation on the basis of location of central mind and management.[108] In such case the composition and activity of the board of directors (and perhaps senior management) normally requires review and reorganization prior to arrival. Similar rules apply for trusts.

[7] The role of an offshore trust

Europeans and other non-North Americans often establish elaborate offshore trust and corporate structures to protect, inter alia, against political upheaval, etc. Such structures may involve the country of immigration.[109] For example, a corporation formed in New Brunswick may act as trustee for an offshore trust, or there may be emergency standby facilities – without engaging liability to Canadian tax where the ultimate beneficiaries are not Canadian residents.[110] Immigration to Canada, however, would likely necessitate review and reorganization of the arrangements prior to arrival, if such Canadian tax status is to be maintained.

[8] The role of an offshore corporation

See III[4][e] and [6] above.

[9] Special regimes and "tax haven" facilities

The peripatetic alien should be aware of certain

96. IRC S.879. See Fogarasi, *Westerdahl Illustrates the Tax Advantage Enjoyed by Nonresident Aliens Domiciled in Community Property Jurisdictions*, TMIJ, Vol. 13, No. 4, April 1984, p.125.
97. See, *Sura v. M.N.R.*, 62 DTC 1005.
98. For example, in respect of such involving the U.K., see Pagan, *International Alimony: How To Make It Tax Efficient*, International Tax Report, January 1985, p.4.
99. See, generally, Boidman, *Planning and Strategy in International Real Estate Transactions and Investments*, Strategy in International Taxation, Vol. I, No. 2, 1985, 91.
100. IRC S.351 and 897(d)(1)(B). But contrary regulations could be made under IRC S.897(e)(2). See Chopin, Granwell and Povell, supra note 87, at 254 et seq.
101. S.69(5), Canadian Act.
102. Under S.88(1) of the Act a 90% or greater owned Canadian corporation may be liquidated on a tax-free basis into a Canadian corporate parent. "Canadian corporation" is defined under paragraph 89(1)(a) of the Canadian Act as constituting a company incorporated in Canada or certain foreign corporations formed prior to 17 June 1971.
103. S.55(3) and 85(1) Canadian Act. See Boidman and Ducharme, *Taxation in Canada – Implications for Foreign Investment*, Kluwer (the Netherlands, 1985) Chapter XXV and Boidman, *Nonresident Investment in Canadian Real Estate*, Corporate Management Tax Conference (1983), Canadian Tax Foundation, p.371.
104. Boidman, supra note 99, at 114.
105. See Blower, *The Less Taxing Way To Structure Your U.K. Property*, International Tax Report, October 1984, p.8 and Blower, *Warning: Time to Rethink Your U.K. Property Plan*, International Tax Report, September 1984, p.3. In 1984 the U.K. also introduced a new 40% withholding tax on sales of U.K. real estate for non-residents. Pagan, *If Foreign Investors Sell U.K. Property*, International Tax Report, September 1984, p.5.
106. IRC S.552(c), enacted by S.132(c)(2), 1984 Tax Reform Act (supra note 3).
107. IRC S.554, S.132(a), 1984 Tax Reform Act.
108. S.250(3), Canadian Act. See Boidman and Ducharme, supra note 14, at p.38 et seq.
109. See, III[4][e] above. See, generally, Klein, *Tax Planning for Fail-Safe Devices*, Prentice-Hall, U.S. Taxation of International Operations, para. 7512, p.7721.
110. See Boidman and Ducharme, supra note 14, at Chapter XXXI.

anomalies or unusual features of tax law in high tax jurisdictions which may present unusual opportunities or traps for the unwary.

It is well known that the U.K. can effectively serve as a tax haven for wealthy individuals with non-U.K. investment income. Provided resident but not domiciliary status is established, investment income which is not remitted to the U.K. is not subject to U.K. tax. See III[3][a]. However, persons of such status may not benefit from tax treaties between the U.K. and other countries in respect of income derived therefrom. See, for example, Article XXVII(2), Canada–United Kingdom Income Tax Convention.

Some aliens obtain landed immigrant status and establish Canadian residence primarily to qualify for Canadian citizenship. Three years is required. If Canadian tax residence status is terminated within five years of arrival, there may be significant avoidance of Canadian taxes. The departure tax (II[2]) does not apply to assets owned at the time the Canadian residence was established.[111] During the period of residence in Canada, the foreign-income attribution rules can be avoided. See, III[4][e].

If an alien terminates U.S. residence within the three years of arrival, liability to U.S. tax under IRC S.7701(b)(9) will not arise (even if residence is re-established within the following three-year period). As well, an alien can use a period of U.S. tax residence to dispose of a U.S. real property interest, pursuant to IRC S.1031 like-kind exchange rules without liability to U.S. tax in respect of either the USRPI or replacement property provided: (1) such replacement property is foreign realty; and (2) the disposition thereof occurs after U.S. residence is terminated.[112]

The U.S. taxes its citizens on worldwide income regardless of residence.[113] A U.S. citizen who expatriates for tax purposes remains liable to U.S. tax on certain U.S.-source income or gains, not otherwise taxable in the hands of an alien non-resident.[114] Not all expatriations will be considered tax-motivated.[115] Arguably some older U.S. treaties may exempt an expatriate from IRC S.877. The Service takes the contrary view.[116] Such position, however, has been rejected in a Tax Court decision handed down in August.[117] See, however, Article XXIX(2), 1980 Canada–U.S. Convention which specifically sanctions the Code rule.

[10] Note respecting estate, gift and inheritance tax considerations

Comprehensive examination of the peripatetic alien's liability to estate, inheritance and gift taxes is beyond the scope of this paper.[118] Some basic points however can be noted.

[a] Scope of taxation

Most countries levy taxes or duties on gifts of property whether made inter vivos or under testamentary device. Canada is an exception; income taxes may, however, apply: see II[6]. The Province of Quebec levies gift and estate taxes but announced on 23 April 1985 that such taxes[119] will be abolished, effective midnight 23 April.[120] All other provinces and the Federal government abolished such taxes in the 1970's.

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111. S.48(4), Canadian Act.
112. See Chopin, Granwell and Povell, supra note 87, at 255 and 256.
113. IRC S.1.
114. IRC S.877. See, generally, Karp, supra note 22.
115. *Furstenberg,* supra note 95.
116. See Karp, supra note 22, at para. 13.02[3][b].
117. On 26 August 1985 the Tax Court filed a decision in *Tedd N. Crow v. Commissioner,* 85 TC 21 [CCH Dec. 42, 339] at 3451, in which it decided that an expatriate was exempt from U.S. tax under IRC S.877 by reason of the provisions of the 1942 Income Tax Convention between Canada and the United States. The taxpayer moved to Canada on 20 November 1978 and renounced his U.S. citizenship on 24 November 1978. It was established that the principal purpose of the expatriation was the avoidance of U.S. tax. On 1 December, the taxpayer sold shares of a U.S. corporation in exchange for a note payable over 20 years without interest and realized a substantial gain. The taxpayer claimed exemption from U.S. tax on the basis of being a resident of Canada and by reference to the provisions of Article VIII of the 1942 Convention between Canada and the U.S. which, generally, exempted Canadian residents from U.S. tax in respect of gains derived from the sale or exchange of capital assets. The Commissioner argued that the taxpayer was liable to U.S. tax by reason of IRC S.877 notwithstanding the Convention because Article XVII of the Convention reserved for the U.S. the right to tax its citizens as though the Convention had not come into effect. Article XVII however did not specifically deal with such right in respect of expatriates. The Service based itself on Rev. Rul. 79-152, 1979-1 C.B. 237, which interprets the term "citizens" in treaty provisions such as Article XVII as including a former citizen who expatriated to avoid tax. The Tax Court, however, concluded that ". . . the contracting parties had no intention to define the term 'citizens' in Article XVII more broadly than its literal meaning . . . Article XVII of the Canadian treaty, however, was intended only to preserve United States taxation of citizens on the basis of citizenship" (at 3452 and 3453). What is of particular interest to a non-U.S. observer is the Tax Court's view as to the role of Revenue Rulings. "Respondent urges us to give deference 'to the view of the Treasury Department' expressed in Rev. Rul. 79-152. A Revenue Ruling represents the view of the Commissioner, not the Treasury Department . . . and thus is generally only 'the contention of one of the parties to the litigation'. . . . Because Rev. Rul. 79-152 does not constitute a consistent and long-standing administrative position with prior Congressional or judicial approval, it is not entitled to any special deference in this Court . . . (at page 3457)." Finally it may be noted that the Service succeeded in treating a portion of the deferred balance of payment as imputed interest under IRC S.483 and, thus, subject to a 15% withholding tax pursuant to Article XI (of both the 1942 and the 1980 Canada–U.S. Conventions).
118. See, generally, Goldberg, *Planning the International Estate,* New York University Proceedings of the 8th Annual Conference on International Tax and Business Planning, Matthew Bender & Company, 1984, Chapter 5; Wyckoff, (PLI) supra, note 87; Goodman, *International Double Taxation of Estates and Inheritances,* Butterworths (U.K.), 1978; *The International Double Taxation of Inheritances and Gifts,* Cahiers de droit fiscal international, Vol. LXXb, IFA Congress, 1985, London (Kluwer). For a comprehensive study of inheritance and gift taxes in 17 European countries see, *A Comparative Study of Inheritance and Gift Taxes in Western Europe,* 24 European Taxation 7-8 (1984) at 211. For a comparative overview of estate taxes in 21 South American countries, see Caballero, *Latin America: Taxation of Gifts and Inheritance Taxes – A Practical Approach,* Bulletin, Vol. 39, No. 2, February 1985, p.55. See also, *The Taxation of Transfers of Family-Held Enterprises on Death or Inter Vivos,* Cahiers de droit fiscal international, Vol. LXIVa (1979); *Current Legal Aspect of International Estate Planning – Foreign Owners of U.S. Property, U.S. Owners of Foreign Property,* Sections of International Law and Real Property, Probate and Trust Law, American Bar Association, 1981 (Robert A. Hendrickson and William K. Stevens, Editors), published by American Bar Association.
119. Arising under provisions of the Quebec Taxation Act, R.S.Q., c.I-3, and the Succession Duty Act, L.R.Q., c.D-13.2.
120. 23 April 1985 Budget Speech, delivered before the Assemblée Nationale by M. Yves L. Duhaime, Ministre des Finances.

Such taxes often apply to worldwide gifts of a "resident" or "domiciliary". With respect to citizens, see [c] below. Such tax may also apply to such gifts of property, "situate" within the host country, made by a person who is not so resident or domiciled.[121]

[b] Domicile

In general, residence or domicile for such purpose constitutes a stronger or more substantial presence or attachment to a country than does residence for income tax purposes. Domicile requires an intention to make a place a fixed and permanent home. A new domicile cannot, however, arise without coupling such intention with physical presence.[122] A person may clearly be a tax resident without being resident or domiciled for gift taxes.[123]

Determinations may vary widely in differing circumstances. A Canadian lived for more than 40 years in the U.K. without becoming domiciled therein.[124] Giving up U.K. domicile may, however, be as difficult as acquiring it.[125]

In *Estate of Paquette,*[126], the taxpayer, a Canadian, spent the better part of 18 years living in the U.S. without becoming domiciled therein. Paquette was a Canadian citizen who in 1950 began making trips to Florida, generally visiting during the winter period. In 1955 he sold his Canadian business and sold his Montreal home but maintained a country home in Canada. He purchased a home in Florida, furnished with furniture from his former Montreal home. From 1957 through 1971 Paquette and his wife divided their time between Florida and Canada. After 1971 his wife remained in Florida throughout, but Paquette continued to return to Montreal in the summers through 1974. In 1971 Paquette also sold his country home in Canada and intended to buy or rent an apartment in Montreal. However, failing health (cancer) intervened. He did return to Canada at least two months a year until 1975 and continued thinking of buying another home in Canada until his death in January of 1975. Paquette filed tax returns in Canada and maintained various Canadian connections such as a driver's licence, Canadian passport and voted in Canada. As well, he maintained the bulk of his assets (cash and portfolios) in Canada. In these circumstances the Tax Court concluded that he had not formed the requisite intention to remain indefinitely in the U.S. and therefore had not become a domiciliary.

An individual can have only one domicile. "The concept of domicile is unitary. A person may reside in two or more places simultaneously. However, he can have only one domicile at a time."[127] Different jurisdictions may however make conflicting determinations as to a decedent's domicile.[128] The rule in the U.K. is the same.[129]

In some jurisdictions a person is deemed to be domiciled for duty purposes after the elapse of a certain period of mere residence. Such occurs in the U.K., for purposes of capital transfer taxes, after 16 years of residence.[130]

[c] Other aspects

The U.S. levies such taxes on its citizens, wherever domiciled.[131] Austria, Colombia, Denmark, Germany, Greece, Italy, Netherlands, Norway, Sweden and Spain also impose such taxes on citizens in varying specified circumstances.[132]

Some countries may tax emigrants. A person is treated as domiciled in the U.K. for three years after he abandons his domicile in the U.K.[133] The U.S. may also levy such taxes on citizens who expatriate for tax avoidance purposes.[134]

As in the case of pre-arrival planning for income tax purposes (see III[4]), the peripatetic alien whose move to a new country may engage domicile therein would consider disposing of assets, directly or in trust, or estate-freezing arrangements prior to engaging domicile.

In some circumstances there may be substantial exposure to double taxation. Such may arise where duties are levied on the same gift (e.g. estate) by the country of citizenship, the country of domicile and the country where the gifted property is situate.[135] Canada's exceptional basis for levying taxes on gifts (II[b]) may result in double tax. No credits for foreign estate or gift taxes are permitted in Canada.[136] Credit may not be allowed for the Canadian taxes against conventional gift or

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121. E.g. IRC S.2101, 2501(a)(1) and (2), and 2511.
122. See Boidman, Chopin and Granwell, supra note 4, p. 161; and Karp, supra note 22.
123. U.S. law refers to "residence" as the nexus to estate or gift tax, but this is equivalent to the notion of domicile, as that term is used in other jurisdictions. Treas. Regs. S.20.0-1(b) (1961) and Treas. Regs. S.25.2501-1(b) (1958); *Farmers Loan & Trust Co. v. U.S.*, 60 F.2d 618 (S.D.N.Y. 1932); *Fifth Avenue Bank of New York ex Rel (Fisher Estate),* 36 B.T.A. 534 (1937), acq. 1937-2 C.B. 9.
124. *Inland Revenue Commissioners v. Bullock,* [1976] 1 WLR 1178.
125. *Official Solicitor v. Clore and Others,* (1984) STC 609.
126. *Est. of Paquette v. Comm'r,* 46 TCM 1400 (1983). Macdonald, *Estate of Paquette v. Commissioner: The Paper Trail to the Yellow Brick Road,* Canadian Tax Journal, Vol. 32, No. 3 (May-June 1984), p.603.
127. Karp, supra note 22, at note 101: *Est. of Bloch-Sulzberger v. Comm'r,* TC Memo 47-304 (1947); *Rodiek v. Comm'r,* 33 BTA 1020, 1033 (1936) *aff'd* 87 F.2d 328 (2d Cir. 1937); *Comm'r v. Nubar,* 185 F.2d 584 (4th Cir. 1959), *cert. den'd* 341 U.S. 925.
128. *Texas v. Florida,* 306 U.S. 398 (1939); *California v. Texas,* 457 US 164 (1982). Karp, supra note 22, at note 102 and related text. Goldberg, supra note 118, at note 3: "See *In Re Dorrance's Estate,* 305 Pa 151, *cert. denied,* 288 US 617 (1932); and *In Re Estate of Dorrance,* 115 NJ Eq 268 (1934), *aff'd 13 NJ Misc 168, aff'd 116 NJL 362, cert. denied,* 298 US 678 (1936), in which both Pennsylvania and New Jersey successfully asserted that they were the decedent's domicile. Note also the present litigation before the U.S. Supreme Court between California and Texas concerning the domicile of the late Howard Hughes."
129. *Somerville v. Lord Somerville,* (1801) 5 Ves. 750.
130. S.267, Capital Transfer Tax Act, 1954. See Greenfield, *Capital Transfer Tax for the Foreign Investor,* TPIR, Vol. 12, No. 10, p.10, and Kieran and Rabin, supra note 11.
131. IRC S.2001 and 2501.
132. See Goodman, General Report, *Cahiers de droit fiscal international,* Volume LXXb, supra note 118, at 24 and 25.
133. S.267, CTTA.
134. IRC S.2107 and 2501(a)(3).
135. See Goodman, *Cahiers de droit fiscal international,* Volume LXXb, supra note 118, at 33-61.
136. Section 126, Canadian Act.

estate tax. Rev. Rul. 82-82[137] holds that tax arising under Canada's deemed disposition at death rules for capital gains tax purposes is not "substantially proven" to be an estate, inheritance, legacy or succession duty and therefore is not creditable pursuant to IRC S.2014. However, the Service would permit a deduction in determining the deceased's taxable estate in respect of such taxes as constituting "claims against the estate".[138]

Consistency in bilateral estate tax agreements is encouraged by the OECD. See The Model Convention for the Avoidance of Double Taxation In Respect of Estates, Inheritances and Gifts, OECD, Paris, 1983.[139]

[11] Taxes on capital and wealth

At present neither Canada nor the U.S. impose taxes on capital or wealth, per se. Such taxes are imposed by some European countries.[140] Such taxes may be onerous for the peripatetic alien.

[12] Information exchanges, bank secrecy laws, etc.

The peripatetic alien may often seek anonymity or confidentiality of financial matters for a variety of business or personal reasons. The radical expansion of exchange of information agreements, and related initiatives, by countries, especially the U.S. and multi-government organizations (e.g. OECD, EEC) are well known.[141] The peripatetic alien's presence in several countries may militate against preserving such anonymity or confidentiality. Initiatives respecting international cooperation for enforcement of tax claims are also developing.[142]

Simply complying with information disclosure requirements of countries such as the United States can be a full-time task. A recent study shows that there are at least 24 important IRS forms relating to U.S. persons, including resident aliens with foreign operations, 26 forms relating to non-resident aliens and foreign corporations, partnerships, estates and trusts engaged in a U.S. trade or business and 16 IRS forms relating to non-resident aliens and foreign corporations, partnerships, estates and trusts not engaged in a U.S. trade or business.[143]

[13] Moving expenses, allowances, etc.

In some circumstances there may be relatively significant tax effects related to expenditures and reimbursements for moving expenses.[144] The IRS considers moving expenses reimbursed by a former employer to constitute foreign-source income whereas if it is reimbursed by the new U.S. employer it constitutes U.S.-source income.[145] See, however, *Dammers v. Commissioner*[146] which held that ". . . even where the taxpayer continues to work for the same employer subsequent to his move back to the United States, the moving expense reimbursement is not necessarily attributable to future services to be performed in the United States".[147]

In Canada, reimbursement from an employer for moving expenses have been held not to constitute income.[148] But an allowance as opposed to reimbursement may be taxable.[149]

IV. ISSUES IN THE COUNTRY OF INVESTMENT OR ACTIVITY

The peripatetic alien's tax situation in a country of investment or other activity may be affected by a per-

137. I.R.B. 1982-18.
138. IRC section 2053(a)(3). This rule was applied previously in LTR 8203135, 21 September 1982 (Technical Advice Memorandum Re IRC S.2014). The propriety of these rulings is confirmed by a Tax Court decision filed on 20 August 1985 in *Estate of Claire M. Ballard, Deceased, Shirley A. Webster, Executor v. Commissioner,* 85 TC 17 [CCH DC. 42, 325] 3413. The deceased U.S. citizen paid tax to Canada in respect of unrealized appreciation in Canadian property pursuant to the deemed disposition rules under section 70(5) of the Canadian Act, discussed above (supra note 38). The Tax Court held that such taxes did not constitute an estate tax for which credit is available under IRC S.2014(a) nor was it of a tax of a substantially similar character to that imposed by Canada prior to 1971 for purposes of the United States–Canada Estate Tax Convention (the provisions of which were terminated by the coming into force of the 1980 Canada–U.S. Income Tax Convention, infra note 173, and thus were not creditable pursuant to that Convention.
139. See Lienard, *OECD: Estates, Inheritances and Gifts,* Intertax 1984/8, p.293.
140. With respect to the 1982 imposition of wealth tax in France see *Net Wealth Tax – Foreigners Domiciled in France,* 23 European Taxation 5 (1983), p.164 and *Net Wealth Tax – U.S. Citizens Domiciled in France,* 23 European Taxation 8 (1983), p.264.
141. See seminar held in London, March 1985, *Disclosure to the Tax Authorities at Home and Abroad* (Business Research International, 20 and 21 March). See, generally, Taxes International (London) which reports continually on developments respecting enforcement, disclosure, bank secrecy and confidentiality. E.g., Jefferson and Johnson, *Cayman Commits Itself to Financial Confidentiality,* 64 Taxes International (February 1985) p.84; Zagaris and Grimes, *U.S. Signs 11 Treaties on Extradiction and Mutual Legal Assistance,* 61 Taxes International (November 1984) p.88. See also Boidman, *International Tax Avoidance – The Impact on Legal Systems,* 1981 International Bureau of Fiscal Documentation – Bulletin, Vol. 35, No. 10, p.435 and Boidman, *Tax Evasion – The Present State of Non-Compliance,* 1983 International Bureau of Fiscal Documentation – Bulletin, Vol. 37, No. 9-10, p.451. See also *International Exchange of Tax Information – Recent Developments* (Gordon and Zagaris), Practising Law Institute, 1985 (Tax Law and Estate Planning Series, Tax Law and Practice, Course Handbook, Series No. 225) 4 June 1985 (New York); Garbis, *United States Tax Investigations Abroad,* Asian-Pacific Tax and Investment Bulletin, Vol. 2, No. 12 (1984), p.515.
142. OECD Model Convention for Mutual Administrative Assistance in the Recovery of Tax Claims, OECD, Paris, 1981 and Goldberg, supra note 118, at 5-64 et seq.
143. See Fishman, *Tax Forms for International Transactions, An Annotated Filing Guide for Practitioners,* The Journal of Taxation, July 1985, p.38.
144. IRC S.82, 217, 862(a)(3) and 911. See, generally, Khokhar, *Moving Expenses and Foreign Related Moves,* TMIJ 83-7, p.14.
145. Rev. Rul. 75-84, 1975-1 C.B.
146. 76 T.C. 835 (1981).
147. Khokhar, supra note 144, at 15.
148. *Ransom v. M.N.R.,* 67 DTC 5235. See also *Revenue Canada Interpretation Bulletin* IT-470.
149. *The Queen* v. *Demers,* 80 DTC 6326. See, generally, *Deductible Expenses – May Expenses Incurred as a Non-Resident Be Deducted from Income Derived as a Resident,* 23 European Taxation 3 (1983), p.88.

sonal change of residence between two other countries. This generally will result from consequential changes respecting entitlement to treaty benefits.

A Canadian resident may be insulated from some if not all effects of being resident in the U.S. under IRC S.7701(b) pursuant to the dual residence rules of Article IV(2) of the 1980 Canada–U.S. treaty. See Part B. Should he emigrate to a tax haven such as the Bahamas, such protection is lost.

A Canadian resident who is entitled under treaty to reduced U.S. (withholding) tax on non-effectively connected U.S.-source dividends, or other items of income subject to tax under the Code, loses such relief if he immigrates to a country (e.g. a tax haven) which does not have comparable treaty relations with the U.S. Recent developments discourage the use of so-called "treaty shopping" arrangements for such person in lieu of the treaty benefits extant under the treaty between the U.S. and his country of emigration.[150]

PART B – HOW THE NEW U.S. RESIDENCY RULES AFFECT ALIENS IN GENERAL AND CANADIANS IN PARTICULAR

V. GENERAL EFFECT OF THE NEW U.S. RESIDENCY RULES

Prior to 1985 the residency status of aliens (e.g. non-U.S. citizens) was, in general, determined according to a facts or circumstances test, as in the manner in many other countries (II[1] and III[2], above). Aliens were presumed to not be residents unless they exhibited an intention to live permanently in the U.S., such intention being assessed by a series of objectively determinable factors.[151] IRC S.7701(b), enacted in 1984 (see II[1]) with effect in the 1985 and following tax years, changes the system entirely. An alien will be a U.S. resident, for income tax purposes, where he meets the largely mechanical tests of IRC S. 7701(b). If he does not, he is a non-resident.[152] These rules have no application to determining residence (domicile) for U.S. gift or estate tax purposes. As noted below, these rules may be modified by treaty.

[1] Lawful permanent resident (green card) test

In general, an alien who holds a valid green card which has not been "revoked (and has not been administratively or judicially determined to have been abandoned)" is a U.S. tax resident.[153] Such residency commences upon entering the U.S. with such status[154] and terminates upon losing such status in the manner noted above.

[2] Substantial presence test

An alien who is physically present in the U.S. for 183 days or more in a year is a resident in respect thereof.[155]

An alien who is physically present in the U.S. for less than 183 days in a year but for at least 31 days and in respect of whom the aggregate of: (1) 100% of days of physical presence in the U.S. during that year; (2) one third of such days for the first preceding year; and(3) one sixth of such days for the second preceding year amount to 183 is a resident in respect of that year.[156] Years prior to 1985 are not taken into account unless the alien was resident in the U.S. on 31 December 1984, or 31 December 1983 and 1984, under prior law.[157] Such alien will not be resident if he has a "tax home" in a foreign country as well as "closer connections" to that country and has not applied for a green card.[158]

"Tax home" is determined pursuant to IRC S.911(d)(3) and means the alien's usual place of business, or, in the absence thereof, his regular place of abode.[159] For this purpose a vacation home in the U.S. is not taken into account. "Closer connections" are not defined. It is very much a subjective mater and, while it is not entirely clear how the U.S. Treasury will interpret this test, it is understood that the approach is based on the concept contained in modern bilateral income tax treaties used to determine the status of an individual who is a resident of both Contracting States (the "tie breaker") and that it will be applied in a

150. Rev. Rul. 84-152, 1984-42 I.R.B. 8 and Rev. Rul. 84-153, 1984-42 I.R.B. 9 and GCM 37940 (24 April 1979, released on 30 January 1985). See Cole and Musher, *Rev. Ruls. 84-152, 84-153 and GCM 37940 Depart from U.S. Treaty Obligations*, TMIJ, Vol. 14, No. 8 (August 1985), p.265; Patrick, *Senate Foreign Relations Committee Hearing on Pending U.S. Income Tax Treaties*, TPIR, Vol. 12, No. 9 (September 1985), p.3; and Granwell, *Treaty Shopping – Recent United States Developments*, TPIR, Vol. 12, No. 9 (September 1985), p.7.
151. See Boidman, Chopin and Granwell, supra note 4, at 147-152.
152. IRC S.7701(b)(1)(B). See, generally, Boidman, Chopin and Granwell, supra note 4; *Residency and Domicile*, (PLI), supra note 87; Khokhar, *New Definition of Resident Alien*, TMIJ Vol. 13, No. 9, September 1984, 283; Roberts & Schwartz, *New Statutory Definition of Resident Alien*, Canadian Tax Journal, Vol. 32, No. 5 (September-October 1984), 969; Karp, supra note 22; Feingold and Schwartz, *An Analysis of the New Law's Tests for An Alien's Status as a U.S. Resident*, Journal of Taxation, October 1984 at 228; Langer, *Congress Creates a Modern-Day Centaur – The Half Resident Alien*, International Tax Journal, Vol. 10, No. 4 (May 1984), p.253; Weinberger, *Aliens under the DRA: Residence vs. Nonresident*, The Tax Adviser, July 1985, 407; Bittel, *The New Definition of Resident Alien for U.S. Income Tax Purposes*, TPIR, Vol. 12, No. 1, January 1985, p.14; Benson, *U.S. Taxation of Foreign Nationals under the 1984 Tax Act: Analysis and Planning*, International Tax Journal, Vol. 10, No. 6, September 1984, p.433; Heizer and Braun, *Working with the New Definition of "Income Tax Resident"*, International Tax Journal, Vol. 12, No. 2, Spring 1985, p.109.
153. IRC S. 7701(b)(1)(A)(i), 7701(b)(5)(A) and (B).
154. IRC S. 7701(b)(2)(A)(i).
155. IRC S. 7701(b)(1)(A)(ii) and (3)(A).
156. IRC S. 7701(b)(3)(A).
157. S.138(b)(2) of the Tax Reform Act, supra note 3.
158. IRC S. 7701(b)(3)(B) and (C).
159. Rev. Rul. 60-189, 1960-1 C.B. 60 and Rev. Rul. 71-247, 1971-1 C.B. 54.

similar manner. See VI[1]. The Secretary is empowered to enact regulations respecting "tax home" and "closer connections".[160]

There are exemptions and exceptions in a number of circumstances involving:

- foreign government personnel, special program teachers or students.[161] The exemption for students may not apply after five years;[162]
- aliens unable to leave the U.S. because of a medical condition which arose in the U.S;[163]
- Canadians and Mexicans who commute regularly to the U.S. to work.[164]

Aliens claiming one of the foregoing exemptions may be required to file a statement explaining the basis thereof.[165]

As in the case of green card status, special rules stipulate residency starting and termination dates on the basis of substantial presence.[166] In applying the provisions of S.7701(b), the general rule is that an alien who has not established a taxable year for any prior period will be treated as having a calendar year as his taxable year.[167] The one exception to this rule applies only to a S.7701(b) resident alien who has established for a prior period a taxable year other than the calendar year. In such case the alien will be treated as a U.S. resident "with respect to any portion of the taxable year which is within such calendar year".[168]

[3] Interaction with treaties

A treaty dual resident "tie-breaker" will override the Code to the extent that a dual resident alien whose residence for treaty purposes is assigned to the other Contracting State will qualify for treaty relief from U.S. tax otherwise exigible.[169]

Such alien will, nonetheless, be a U.S. tax resident, entailing all consequences and obligations (e.g. the requirement to file tax return Form 1040)[170] not specifically excluded by the relevant treaty.[171]

[4] Some general observations

There will no longer be much uncertainty respecting an alien's U.S. residency status. Certain areas remain subjective or susceptible to interpretational difficulties.

Some effects will be surprising and largely unintended. The legislation may be more applicable, in practice, to those to whom it was not directed than to those it was.

There are no safe harbors for a temporary executive transfer (e.g. for longer than six months) or even for pure tourists who overstay the day count rules. On the other hand, foreigners who habitually vacation in the U.S. will not become resident if they restrict their annual visits to 121 days in each (of three) consecutive year.

Foreigners no longer will have the luxury of holding green cards for "future use" without (tax) cost.

Each alien is assessed under the rules on his own facts and (no longer) will affect the U.S. residency status of a family member or have his status affected by such persons. This may well present "planning opportunities", particularly when considered in the context of treaty "tie-breaker" rules.

VI. PARTICULAR ISSUES FOR CANADIANS

Canadians spend substantial time in the U.S. – working, travelling for work or pleasure, and vacationing. Many own homes, either in bordering vacation/resort areas or in the sunny climes of the South, West Coast or Hawaii. They will probably be most affected by the new Code rules, regardless of the purposes for which they were enacted. Inasmuch as Canada also has a well-developed, high-rate tax system, applicable to world-wide income of Canadians (II[1] above) and will generally treat a long-term Canadian who has not severed substantially all ongoing residential ties to Canada as a resident (II[1] above), many Canadians may well face burdensome dual resident status. The treaty between Canada and the U.S. may, however, ameliorate the situation in most if not all cases.

[1] Treaty tie-breaker

A Canadian who is considered resident of both Canada and the U.S., under domestic law, will be deemed a resident of one country or the other, but not both, for treaty purposes in accordance with Article IV(2) of the 1980 Canada–U.S. Income Tax Convention.[172] The treaty was ratified in 1984 and, generally, is applicable commencing in 1985.[173] The tie-breaker consists of five tests, to be applied sequentially.

[a] Permanent home

If a dual resident has a "permanent home" available to him in only one of the countries, he will be a treaty resident of such country.[174] The Convention does not explain the rule or its constituent terms; nor does the

160. IRC S.7701(b)(10).
161. IRC S. 7701(b)(3)(D)(i) and 7701(b)(4).
162. IRC S.7701(b)(4)(E)(ii).
163. IRC S.7701(b)(3)(D)(ii).
164. IRC S.7701(b)(6)(B).
165. IRC S.7701(b)(7).
166. IRC S.7701(b)(2)(A)(iii), (C).
167. IRC S.7701(b)(8)(A).
168. IRC S.7701(b)(8)(B).
169. H.R. Rep. No. 432 (Part II), 98th Cong. 2d Sess. at 1528 (1984). See VI below.
170. Rev. Proc. 84-79, TRB 1984-47, 33.
171. H.R. Rep. No. 861, 98th Cong. 2d Sess. at 967 (1984). See Boidman, Chopin and Granwell, supra note 4, at p.157-60, 184, 190-194 and 197-200.
172. Supra note 59. For a detailed discussion, see Boidman, Chopin and Granwell, supra note 4, at 184 et seq.
173. See Boidman, *The New Canada-U.S. Tax Convention – The Effective Date Rules,* TMIJ, Vol. 13, No. 10, October 1984, p.346; and Boidman, *New Canada-U.S. Treaty: Effective Dates and Transitional Issues,* Canadian Tax Journal, Vol. 32, No. 5, September-October 1984, p.909.
174. Article IV(2)(a), 1980 Convention.

Treasury's Technical Explanation.[175] It is not clear if a vacation home is a "permanent home".

[b] Center of vital interests

If Rule 1 is not determinative, the Canadian's status is, next, assessed by reference to his "center of vital interests".[176] As in the case Rule 1 (and the Code notion of "closer connections" (V[2] above), this rule or its essential concept is not explained, in the Convention or the Technical Explanation.[177]

[c] Habitual abode

If Rule 2 fails, status will be determined by reference to the Canadian's "habitual abode".[178] As above, the concept is not defined by the Convention. It is explained by the OECD as comprising the country "where he stays more frequently".[179]

[d] Country of citizenship

If Rule 3 fails, reference is made to the country of citizenship.[180] If the resident involved is a U.S. citizen, the exercise is inapplicable because such person is, largely, excluded from relief under the Convention from U.S. tax.[181] If the resident involved is a Canadian citizen, he is deemed a treaty resident of Canada.[182]

[e] Competent authority

If the resident is a citizen of both or neither country, the case is referred to the competent authority.[183]

[2] General effects of tie-breaker[184]

[a] Status resolved in favor of Canada

Where the individual resident's status is resolved in favor of Canada, he must nonetheless file a standard U.S. return. V[3] above. Revenue Canada's understanding is otherwise. See "Information Statement" released by Revenue Canada, Taxation on 20 June 1985 which is said to be ". . . for the purpose of informing those Canadian citizens who take protracted holidays in the United States, of certain changes to U.S. domestic tax laws". The release states that the status of a dual resident will be resolved under the treaty so as to ". . . ensure that such individual will only be taxable in one of the two countries". This does not seem to be accurate. It also states "the Internal Revenue Service has indicated that where the Convention overrides the United States residency rules, that the United States may require such individuals to file United States income tax returns (Form 1040NR) and include therein any income from sources outside Canada. However, we believe that they will only be required to attach to the United States return a statement that they are exempt from tax in the United States on all non-U.S.-source income pursuant to paragraph 2 of Article IV of the Convention." Again this seems to be inaccurate.

Such taxpayer is entitled to reduced rates of U.S. tax or exemption therefrom as specifically proved by the 1980 Convention. However, he is not entitled to exemptions under the Code applicable to non-resident aliens. For example, the exemption from U.S. tax for interest paid by banks would not apply.[185]

Such taxpayer is entitled to domestic (Code) relieving provisions or benefits restricted to U.S. residents. For example, Code non-recognition rules such as section 1031 apply to such taxpayer's U.S. real property interests in contrast to the rules for an alien non-resident.[186]

Such taxpayer should be exempt from liability to tax under FPHC rules (III[4][e] above) notwithstanding uncertainty raised by the language of Technical Explanation.[187] His status, however, could affect other U.S. shareholders. He would, however, be subject to Code taxes, such as the IRC S.1491 excise tax, not covered by the Convention.[188]

Payments made by such taxpayer would have a U.S. source and thus could subject a non-resident recipient to U.S. tax. For example, his interest payments would be considered to have a U.S. source and thus subject to U.S. tax subject to treaty exemption.[189]

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175. *Treasury Department's technical explanation of the U.S.–Canada income tax treaty signed on 26 September 1980 as amended by protocols signed on 14 June 1983 and 28 March 1984,* P-H Federal Taxes, Tax Treaties I, para. 22,065. Reference should be had to the official commentary on the Model Double Taxation Convention on Income and Capital, OECD, Paris (1977), on which the 1980 Convention is patterned. A December 1982 decision of the French Supreme Administrative Court, reported recently, is of interest with respect to this aspect of a treaty tie-breaker. In that case, the French Court decided that a person with substantial involvement in France but who claimed treaty residence in Spain had a permanent home available to him in France notwithstanding that he had sublet the premises through the years in question to a third party. See *Decision of the Supreme Administrative Court (Conseil d'état) of 21 December 1983,* 25 European Taxation 7 (1985), p.198. (The judgment is #27,685 reported in Revue de Jurisprudence Fiscale, 2 (1984) at 54.) According to the report in European Taxation, the circumstances surrounding the home were as follows:
"The taxpayer, T, rented an apartment in Nice, France, from 1970 to 1973. As from 1970, he sublet to Y and, by a recorded act, the sublet became official in March 1972. At all times during the years in question, T maintained a residence in Spain. . .. The Supreme Administrative Court concluded that T had a permanent home in France. Although T had sublet his apartment in Nice, the Court determined that the sublease was of a fictitious character because:
1. T continued to receive mail at the Nice address and never informed the Nice bank where he had an account of any other address;
2. T's name was indicated at the entrance of the building; and specially
3. The apartment was equipped with a teleprinter."
176. Article IV(2)(a).
177. Again, see OECD Model Treaty and Commentary, supra note 175.
178. Article IV(2)(b).
179. Paragraph 17, Official Commentary on the 1977 OECD Model Income Tax Convention, supra note 175.
180. Article IV(2)(c).
181. Article XXIX(2).
182. Article IV(2)(c).
183. Article IV(2)(d).
184. See also, V[3] above.
185. IRC S.861(a)(1)(A) and 861(c)(1). See also Boidman, Chopin and Granwell, supra note 4, at 190 et seq., especially 193.
186. IRC 897(e)(1).
187. See detailed analysis, Boidman, Chopin and Granwell, supra note 4, at p.190 et seq.
188. Article II, 1980 Convention.
189. IRC S.861(a)(1). But see Article XI(2), (6) and (8) of the 1980 Convention.

[b] Status resolved in favor of the U.S.

Assuming status is resolved in favor of the U.S., mirror image effects (as modified by the differences in the domestic tax systems of the two countries) as those examined in [a] above will arise where the dual resident's treaty status is resolved in favor of the U.S. under the tie-breaker.[190]

[3] Some unresolved issues for Canadians

The foregoing should make clear that the new residency rules will not affect, in a substantial fashion, the majority of Canadians who may spend substantial time in the U.S. Nonetheless, they will certainly create, at minimum, a heightened awareness of U.S. tax law among such Canadians, generally, require record keeping and the filing of certain information with the Service in some cases and, in the case of Canadians who engage U.S. residence status under the Code rules, lead to ongoing reporting requirements and in some circumstances uncertainty of overall results, particularly over the next few years before the administrative procedures or judicial determinations have been worked out and evolved. Some of the unresolved issues for Canadians include the following:

1. Is a Canadian's vacation home in the U.S. a "permanent home" for Article IV(2)(a)?
2. Does the "commuter" rule (V[2]) apply to commercial travellers who make frequent visits to the U.S.?
3. Will the IRS insist upon a full tax return (Form 1040) from dual residents who are Canadians under Article IV(2)?
4. Will the IRS consider FPHC applicable, notwithstanding apparent effects of the Convention to the contrary?
5. What is the status of a dual citizen?
6. For elderly Canadians with chronic medical conditions, will the "medical" exception (V[2][b]) be applicable, where relevant?
7. Will Canadians using U.S. cottages during weekends inadvertently meet the substantial presence test?
8. Given Canada's facts and circumstances test for residence, is there a risk that uncertainty respecting termination of Canadian (domestic) residency may adversely affect pre-departure planning (see II[4] and [5])?
9. Will it always be clear that a Canadian who decides to abandon a green card or believes it has expired due to lack of use no longer has "lawful permanent resident status" for purposes of IRC S.7701(b) by reason of such status having been "revoked" or "administratively or judicially determined to have been abandoned"?[191]
10. What are the associated results for dual resident Canadians under (U.S.) State and (Canadian) Provincial law?[192]

VII. SUMMARY COMMENT

The foregoing should make amply clear that the peripatetic alien may face a variety of (income and other) tax issues in the U.S. and other countries. Although careful planning both in respect of the country of immigration and emigration may sometimes serve to ameliorate the tax burdens otherwise arising, it will generally be difficult to totally avoid such results where such aliens migrate permanently to or spend substantial time in such countries. Common patterns of taxation in many countries may tend to simplify preliminary and initial assessment of the overall requirements and desirable planning techniques but the multiplicity and differences of the rules in each country clearly make it impossible to assess them fully without detailed study of the particular facts and the tax rules involved. It is hoped that the foregoing at least serves to provide an initial format or starting point in dealing with any particular situation.

190. See full discussion, Boidman, Chopin and Granwell, supra note 4, at p.194 et seq.
191. See Khokhar, supra note 152, at 289 and 290.
192. See discussion, Boidman, Chopin and Granwell, supra note 4, at 200.

THE INTERNATIONAL CHAMBER OF COMMERCE (ICC)

Review of Activities of the ICC Tax Commission

By Jacoba Helfrich-Laubrock

The International Chamber of Commerce (ICC) is widely regarded as one of the staunchest defenders of trade liberalism and the principles of a free market economy. Catering to the wishes of its worldwide membership, the Chamber raises its voice whenever it feels that international policy making infringes on a free and liberal framework for international business activities. Among the multifold issues the ICC deals with, tax questions have always taken an important place. Covering a broad range of topics, the ICC Tax Commission under the presidency of Mr. Wolfgang Ritter, Chief Legal Counsel of BASF, AG, actively contributes to the shaping of the international tax environment.

This article provides a brief account of the various taxation issues the commission has taken up. It is preceded by a portrait of the ICC and its various activities.

1. THE INTERNATIONAL CHAMBER OF COMMERCE

The International Chamber of Commerce (ICC) is the only world business organisation. It counts 7,000 members – companies and business associations in more than 100 countries the world over. There are ICC National Committees in Asia, North and South America, Africa, the Middle East and Europe, which coordinate national and regional business views within the ICC. Founded in 1919, the Paris-based organisation promotes trade liberalism based on free and fair competition, free trade and free movement of capital and encourages international investments. It strongly believes in self-regulation by business.

The ICC supplies a range of practical services to business. They include the ICC Court of Arbitration in Paris and the ICC International Maritime Bureau in London which combats maritime fraud. The ICC also draws up rules on the mechanics of trade – for example on documentary credits, which are used to effect payment for goods worldwide, and on Incoterms, the definition of terms used in international trade.

Above all, it is the ICC's task to monitor the work of intergovernmental institutions and to express the viewpoint of the business sectors to which decisions taken will apply. It is the Chamber's goal that such decisions will be in harmony with an undisturbed development of international trade and business life. In fact, the ICC plays the same role on the international level vis-à-vis these international public authorities as the national chambers of commerce and the professional associations play vis-à-vis the government and authorities in their respective countries. The ICC has first-category consultative status within the United Nations system including the specialized U.N. agencies. It keeps liaison offices in New York and Geneva in order to monitor the many U.N. activities which directly concern business. The organisation also maintains close relations with the European Community, the Organisation for Economic Co-operation and Development (OECD), the GATT, and other international organisations.

Jacoba Helfrich-Laubrock is an executive with the German National Committee of the ICC. She coordinates the views of German business on tax, environment, insurance and energy matters to assist the respective ICC commissions with their work. Before joining the ICC, Ms. Helfrich-Laubrock was a member of the German Foreign Service. After two years with the Foreign Ministry at Bonn, she spent close to four years with the German Embassy at Washington, D.C. In the rank of second secretary, she served as a staff aide to the ambassador and as attachée for press and public relations. Born in 1950, Ms. Helfrich-Laubrock graduated from the University of Mannheim with a Master's Degree in Economics and received the Certificat de Hautes Etudes Européennes from the Collège d'Europe at Bruges, Belgium.

Seventeen ICC commissions develop and formulate the position which the ICC takes on the numerous and highly diversified issues addressed by international organisations. The commissions deal with as broad a range of subjects as sea and air transport, marketing, banking, monetary affairs, telecommunications, energy, the environment and relations between multinationals and their host governments. One of the most active commissions is the ICC Tax Commission which brings together as its members leading experts in the field of international taxation. The Commission is headed by Wolfgang Ritter, Chief Legal Counsel of BASF AG.

The Commission works in the field of taxation for the overall goals of the International Chamber of Commerce – free trade and free movement of capital and the promotion of international investments. The Commission thus fights protectionist tendencies by means of taxation and supports international cooperation to create a fair and unbiased tax system governing international tax relations. Following is an account of some of the issues the Commission has dealt with during the recent past and the steps it has taken to gain acceptance of its views.

2. ACTIVITIES OF THE ICC TAX COMMISSION

International cooperation of tax authorities

The ICC is aware of the keen interest tax authorities of different countries take in close international cooperation to secure the levy of their respective taxes. However, the ICC stresses the necessity to have such cooperation exercised in a way that recognizes the needs of international commerce and investment as well as the legitimate interests and rights of the taxpayer. The ICC has therefore taken a critical view of various attempts to provide for increased administrative assistance from international agreements. Only recently, the ICC has urged the Council of Europe to abandon its project of a Convention on Mutual Administrative Assistance in Tax Matters. The ICC questions the need for such a convention as there already exists an elaborate network of international tax treaties. In regard to the draft convention the ICC raises the following objections:

1. The draft makes no clear distinction between tax evasion and tax avoidance. Though ICC does oppose tax evasion, it does not oppose legally-admissible tax avoidance. The ICC is of the opinion that the taxpayer has the right to minimise his tax burden by every legitimate means and that this should be recognised.
2. The ICC also stresses that the draft lacks defined standards for the information to be exchanged as well as legal definition of the terms "spontaneous" and "automatic exchange".
3. There is no provision of the draft which would provide for the taxpayer's right to a hearing in advance of any transfer of information. Also, there is no provision which would grant the taxpayer the right of a court appeal.
4. The ICC, finally, stresses that the taxpayer's protection from discrimination and double taxation would require substantially amplified consideration in the draft convention.

Resolution of international tax conflicts

The ICC has also finished a study on the resolution of international tax conflicts which comments on and proposes certain modifications to the mutual agreement procedure standardised by the OECD, presently the accepted method for resolving disputes under most double taxation conventions. Striving towards a more efficient and consistent application of tax laws, the study proposes rules which would broaden the taxpayer's right vis-à-vis the competent tax authorities to initiate the procedure, ensure that every such procedure be limited in scope to the issues presented, establish firm deadlines for settlements and strengthen enforcement policies.

In the event of unsuccessful resolution of disputes, the study advises the initiation of arbitration procedures and outlines basic governing principles.

Tax relations between developed and developing countries

So far, the ICC has always implicitly recognized the different interests of developed and developing countries in regard to tax treaties both on a bilateral and multilateral level. In the opinion of the ICC, it is important that such nations understand each other's aims and ambitions and that the entrepreneurial taxpayers' activities may not be crushed by double or excessive taxation. For example, the ICC recognizes that the country of source may have a legitimate interest in the taxation of royalties and interest, but that any tendency to overtax by applying high withholding rates without regard to the costs incurred in producing the income should be resisted. On the other hand, the ICC also advocates that the developed country should respect the fiscal policies of the developing countries by tax exemption or by a system of "matching credits" for the fiscal incentives (pioneer reliefs, etc.) granted by such developing countries.

For years, the ICC has therefore closely monitored the work of the UN ad-hoc group of experts on international cooperation in tax matters. When the group met in December 1985 to consider possible amendments or supplements to the UN model tax convention between developed and developing countries, the ICC took a strong stand on improving certain provisions of the model. In general, the ICC's comments were concerned not only with avoidance of excessive and double taxation, but also with undue negative effects on international trade and investment.

More specific requests of the ICC are: the return to the concept of permanent establishment as contained in the 1977 OECD model; the adoption of limits on the rates of withholding tax on dividends, interest and royalties; the preservation of tax incentives in case the credit method to avoid double taxation is applied; and significant changes in the mutual agreement procedure envisaged by the convention to achieve fair and equitable treatment of all parties involved.

Unitary tax laws

During the past years, the ICC, in relentless effort, has strongly opposed unitary tax laws as they are in force in some U.S. states. The ICC rejects unitary taxation as derogating from the accepted international principle of arm's-length transactions, failing to adequately protect minority stockholder rights, increasing accounting and administrative costs, and impeding new business start-ups. At various times, ICC has urged the U.S. Federal Government to exert pressure on state authorities to abandon unitary taxation. In consequence, the U.S. Federal Administration's announcement (November 1984) of its intention to initiate and promote the passage of federal legislation, effecting a requirement that multinationals be taxed by states only on income derived from the territory of the United States (water's-edge requirement), has been welcomed by the ICC. Though a number of U.S. states have given in to the Federal Government's urging and have abandoned unitary tax laws, the ICC continues to call for federal action in the problem areas which still remain. Among these, proposed legislation in California is of special concern; it contains onerous information requirements, does not define the water's-edge so as to limit the reach of the state on a basis comparable with a permanent establishment approach, and gives state tax authorities the power to disregard election by a corporation of the water's-edge option.

Harmonisation of European tax systems

The ICC views the international harmonisation of tax matters as a basic vehicle to stimulate and promote the development of business and investment activities. It therefore follows with great interest the various attempts undertaken by the EC Commission to harmonise the tax systems of EC Member States, noting not only the impact on EC members, but also the potential precedental effect on the fiscal policies of non-EC countries. As a result, the ICC has repeatedly urged the Commission to give highest priority to such harmonisation.

During the more recent past, the ICC has commented on various EEC draft directives in the field of tax harmonisation, thereby adhering to its goal of liberalising the tax environment and equalising the tax burdens of business in different countries. Recently, the ICC has given careful consideration to three current EEC draft directives, namely those dealing with the carry-over of losses, with capital duty and turnover taxes (14^{th} Directive). The ICC views each one of the drafts as an important step towards stimulating business and investment, yet the ICC makes some minor suggestions as to how the drafts could be improved even more towards fulfilling these goals.

Tax treatment of interest in international loan transactions

The free movement of capital across state boundaries has been, and continues to be, the key factor in economic development. It is therefore of utmost importance that measures taken in individual states with regard to the taxation of interest on loans and the provisions of international conventions for the avoidance of double taxation should not jeopardize the free movement of capital. The ICC calls upon governments to take greater account of the impact of national tax policy on the treatment of interest in international loan transactions, as such policies can play an important role in stimulating or inhibiting international movements of capital. The ICC therefore has issued a statement supporting recent measures providing for favorable treatment of interest such as those stipulating that interest on certain international bonds may be paid to non-residents free of withholding taxes. However, many fiscal barriers remain in this field and the ICC considers that discrimination against international credit transactions has not yet been eliminated. The ICC therefore recommends a number of measures intended to abolish remaining obstacles to the free movement of capital.

AUSTRALIA:

Foreign Exchange Gains and Losses

By D.C. Orrock

Until the introduction (with effect from 20 September 1985) of a capital gains tax, a gain or loss on the conversion of a currency required a determination as to whether it was an item of income or capital.

The extent to which a gain is considered to be assessable income, and a loss incurred is an allowable deduction for Australian income tax purposes, is laid down in sections 25 and 51 of the Income Tax Assessment Act.

The deductibility under section 51 of the Act of losses and outgoings must be reviewed in the various categories of deduction embraced by that section, viz:

(a) losses or outgoings incurred in gaining or producing the assessable income;
(b) losses or outgoings necessarily incurred in carrying on business for the purpose of gaining or producing assessable income; and
(c) losses or outgoings related to the purchase of trading stock.

Losses or outgoings incurred in relation to categories (a) and (b) are subject to the exclusion of any expenditure which is related to capital or is of a capital, private or domestic nature as provided for in section 51.

Of importance in this area are the provisions of section 20 of the Assessment Act, which section states:

> For all purposes of this Act, income wherever derived and any expenditure wherever incurred shall be expressed in terms of Australian currency.

The provisions of section 20 have rarely been the subject of judicial interpretation. A decision by Board of Review No. 2 (16 CTBR (NS) Case 31) dealt with the assessability of a gain on foreign exchange arising from the devaluation of Sterling. It was unanimously held that the terms of the section seemed to determine the case against the Commissioner.

The Board held that, for the purposes of section 20, the date on which the overseas transaction is to be expressed in Australian currency is the date when the outgoing is incurred. Since the outgoing was incurred prior to the date of devaluation it was properly expressed in Australian dollars at the rate of exchange existing prior to the devaluation. The cost to the taxpayer was therefore correctly stated in its income tax return. The subsequent gain to the taxpayer as a result of the conversion of its Sterling bank overdraft balance ". . . was simply an adventitious advantage which was not in the nature of income . . .".

It is to be noted that section 20 refers to "income". In his book *Principles of Income Tax* (at page 1), the late Mr. J.P. Hannan, LL.B., referred to "income" in the following terms:

> The word income is of such elusive import that it cannot be defined in precise terms which would adequately meet legislative requirements. Why its meaning is not to be found in any income tax statute is explained by the many shapes which income may assume, and the illimitable variety of circumstances in which it may be derived.

Consequently, the conception of what is income for accounting purposes and taxation purposes may be widely divergent.

Section 20 also refers to "expenses" whereas section 51 refers to "losses and outgoings" when prescribing the nature of expenditure which may be claimed as a deduction against assessable income. It would appear that the terms "income" and "expenses" contained in section 20 should be construed as "incomings" and "outgoings" rather than income or deductions in the accepted sense.

From the abovementioned Board of Review decision it will be seen that the point of time at which the income or expenditure is expressed in Australian currency is of vital importance.

For Australian income tax purposes it may be said that the gain or loss in respect of the currency revaluation is assessable or deductible only in the year of income in which the gain or loss is actually realised. Authority for this reasoning is provided by the decision in *Texas Co. (Australia) Ltd. v. FC of T (1940)* CLR 382; 5 ATD 298.

Once again the accounting and taxation concepts can vary in determining the point of time at which a gain or loss is considered to have occurred or is to be recognised.

On 18 February 1986 the Australian Treasurer made the following statement on the taxation treatment of foreign exchange gains and losses:

> In the 19 September 1985 statement on Tax Reform, under the proposed arrangements for the capital gains tax (CGT), it was noted that the taxation treatment of foreign exchange gains and losses was an outstanding issue yet to be decided.
>
> The Government has now decided that all future foreign exchange gains and losses which are in the nature of interest are to be treated on revenue account, i.e. gains would be assessable and losses deductible for income tax purposes.
>
> Specifically, foreign exchange gains and losses realised after today in respect of:
>
> > borrowings or loans contracted for after today,
> >
> > all delayed payments for acquisition of assets and delayed receipts for sales of assets under contracts entered into after today, i.e. exchange rate effects between the contract dates and the dates of actual payment or receipt of purchase moneys, or
> >
> > instalment purchase arrangements contracted for after today,

are to be assessable or deductible respectively for income tax purposes.

Consistent with this treatment, premiums and discounts associated with forward cover and other hedging contracts entered into after today in respect of overseas borrowings or lendings contracted for after today, or in respect of sales or purchases of assets contracted for after today, are also to be treated on revenue account.

For these purposes, the contract date of each borrowing under a drawdown facility will be taken to be the date on which the borrowing is actually drawn down.

As an anti-avoidance measure, a deduction is to be denied foreign exchange losses covered by a hedging contract or similar arrangement, where the hedging contract produces a gain which is not assessable income of the Australian resident taxpayer. It will apply whether the arrangement is entered into directly by that taxpayer, through an associate or by an arm's length party under a reimbursement agreement.

Where an asset such as plant or shares is sold overseas by an Australian taxpayer, exchange rate gains or losses between the purchase and sale contract dates will be taken into account under the CGT arrangements. That is, the indexed CGT cost bases of these assets and the prices of their foreign sales will take into account relevant exchange rate movements.

The legislation to give effect to the foregoing statement has not yet been enacted.

It means, of course, that the tax treatment of exchange gains and losses will be determined by one of two alternative regimes – the existing position as per current and future case law on sections 20, 25 and 51 or as per the amending legislation yet to be introduced.

In recent years the Australian Courts have adopted several approaches in determining whether losses or gains in foreign currency were on income or capital account.

Those approaches have included:

(1) treating the foreign currency variation as a separate transaction; and
(2) viewing the foreign currency transaction as being integrated with the underlying transaction.

The general principle which has emerged from these decisions is that if a taxpayer incurs obligations and, before the obligations have been satisfied by payment, there is a variation in the rate of exchange which involves him in a loss on exchange – that loss may be an allowable deduction in the year of payment, subject to the limitations imposed by section 51(1).

The deduction is allowable if, and to the extent to which, it refers to liabilities on revenue account, but not if, and the extent to which, it refers to liabilities of a capital nature.

This principle, which appears to conform with the general principle that losses on revenue account, but not on capital account, are an allowable deduction, was laid down in the Texas Co. Case cited previously.

While that basic principle persists, the complexities and variety of current international business transactions have thrown up inconsistencies in later decisions which defy reconciliation of the several judgments. This is particularly so in the case of borrowings or lendings as distinct from the purchase or sale of trading stock.

The question of the treatment of exchange gains or losses in respect of borrowings or lending transactions by taxpayers other than finance companies was considered by the Federal Court in *FC of T v. Hunter Douglas Ltd.* (ref. 83 ATC 4562).

The taxpayer in question, a manufacturer, borrowed funds overseas to increase working capital. The loan facility was drawn down as required to fund day-to-day business outgoings. Exchange losses were incurred.

The majority of the Court looked to the purpose of the borrowing in order to determine its character rather than the use to which the borrowed funds were put. The purpose was seen to be ". . . to strengthen the business structure or organisation of the taxpayer to enable it to provide a stronger base or entity with which to carry on business and earn profit" (quoted from judgement of Lockhart J.).

Thus borrowings are viewed as part of the company's capital structure which is transmitted to the gains or losses resulting from currency fluctuations. The borrowing of funds for the acquisition of trading stock is an exception, being on revenue account.

A further exception is in the case of finance companies borrowing in the ordinary course of their business of lending money, being akin to the funding of trading stock.

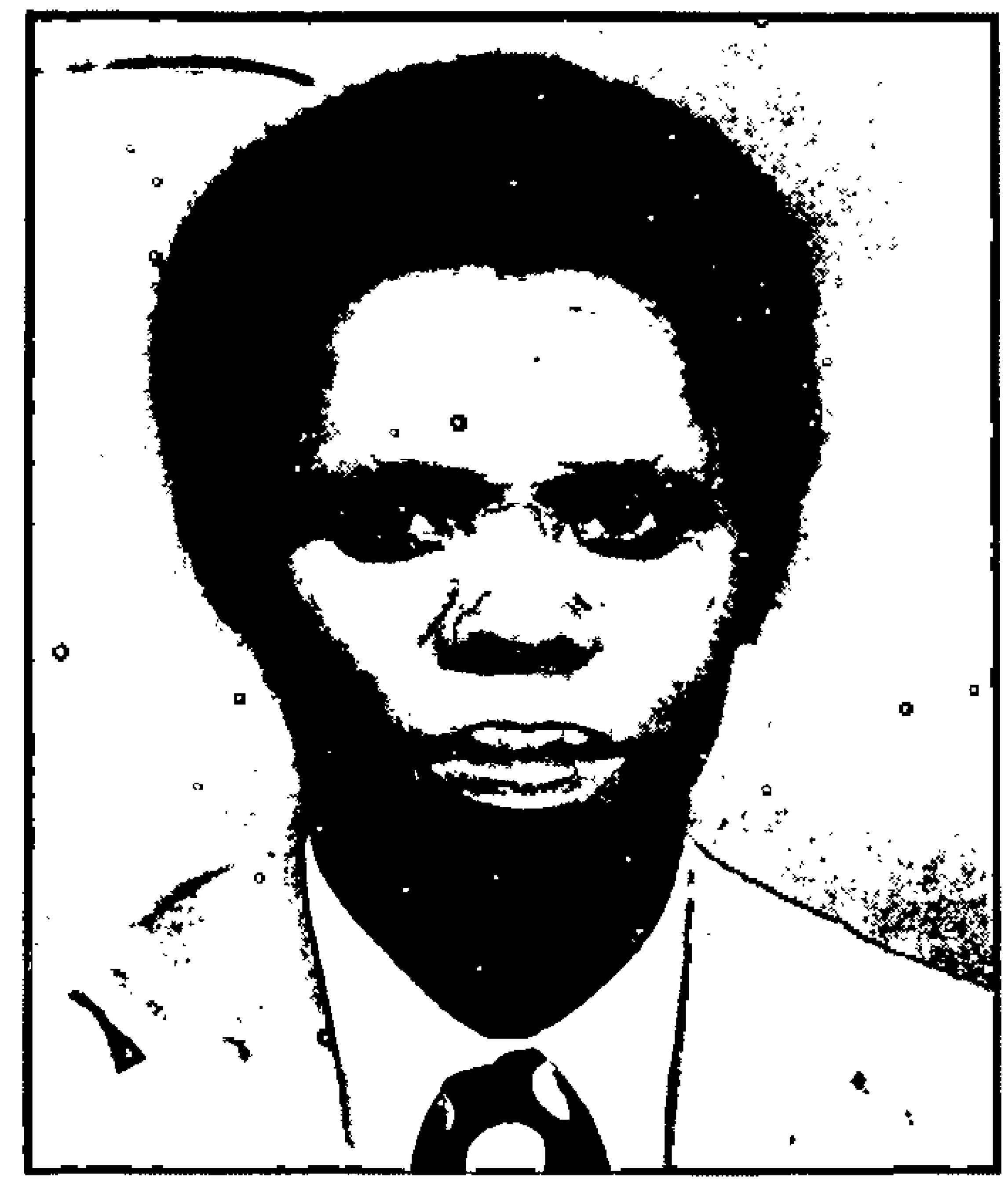
While the foregoing general principles have been established it is expected that the significant losses incurred by Australian taxpayers as a result of the fall in the value of the Australian dollar in recent years will create further challenges. We can except further developments in the application of these principles before pre-February 1986 borrowings are extinguished to enable the "new rules" to operate in isolation.

Nigeria's Petroleum Profits Tax

By Professor A.C. Ezejelue

I. INTRODUCTION

In view of the special and complicated nature of the petroleum industry generally, companies engaged in the winning of oil are not taxed, as other companies, under our general Companies Income Tax Act 1979 as amended. Oil companies come under a separate tax law known as the Petroleum Profits Tax Act 1959. As will be seen shortly, this principal Act has been overlain by several subsequent decrees. The amendments to the principal Act have been necessitated partly because of the changes in the fiscal policies of Nigeria and partly because of international influences. The Nigerian practice in the oil industry cannot be totally divorced from the practices which obtain elsewhere in the international petroleum industry. The Nigerian practice manifests, to some extent, practices prevailing elsewhere in the oil industry, homogeneity having been achieved through the employment of "most favoured nation" and "most favoured company" clauses, as well as through collective bargaining under the auspices and influence of OPEC.



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The powers to assess, collect, and account for the petroleum profits tax in Nigeria are vested in the Federal Board of Inland Revenue by virtue of the principal Act which came into force on 1 January 1958, two years after which oil was struck in commercial quantity in Nigeria. Although production of oil for export started in 1958 in Nigeria, search for oil dated back to 1937 when licence was granted to Shell d'Arcy Company Limited.[1]

This paper will, among other things, briefly outline the several enactments dealing with Nigeria's Petroleum Profits Tax. Thereafter, it will discuss the ascertainment of various profit concepts applicable to petroleum tax, ascertainment and imposition of taxes, capital allowances, and other essential provisions in relation to taxation of petroleum profits in Nigeria.

II. ENACTMENTS IN RELATION TO PETROLEUM PROFITS TAX

As was said earlier, the principal act is the Petroleum Profits Tax Act 1959. Since 1966, this Act has been amended by several decrees. In brief, the situation is as follows:

(a) The Petroleum Profits Tax Act, 1959:

This act basically embodies the 50/50 profit-sharing arrangement, with profits calculated on the basis of realised prices, not on "posted prices".[2]

(b) The Income Tax (Amendment) Decree (No. 65) 1966:

The relevant amendment in this Decree affects mainly the rate of capital allowances, nearly slashing by ½ the figures in the 1959 Act.[3]

(c) The Petroleum Profits Tax (Amendment) Decree (No. 1) 1967:

This Decree incorporates into the principal Act, the Royalty-Expensing Agreements. It also sought to relate "realised prices" to "posted prices" – profits to be calculated on "posted prices" minus any allowances conceded by the Federal Government of Nigeria.

(d) The Oil Terminal Dues Decree (No. 9) 1969:

This Decree which took effect from 1 January 1965 provides that terminal dues[4] may be levied, subject to the provisions of this Decree and the Ports Act, on any ship evacuating oil at any oil terminal[5] and in respect of any services or facilities provided under this Decree. The Decree also incorporates in its second schedule the "Convention on the Continental Shelf".[6] This Decree has no direct bearing on the 1959 Act.

1. The company was later known as Shell-BP Petroleum Development Company of Nigeria Limited.
2. "Posted prices" are price quotations by means of which the international petroleum industry sells and buys crude petroleum and refined petroleum products. Posted prices being merely a statement of intention may or may not be the actual market price at which crude oil passes hands. Today, posted prices have ceased to serve as actual prices at which crude oil is sold or bought.
3. See section 13(4) & (5) of Decree No. 65 of 1966 and schedule 3 thereto.
4. "Terminal dues" means such dues as may be levied on any ship evacuating oil at any oil terminal.
5. "Oil Terminal" is an oil-lading terminal, pumping or booster station, or other installation (or structure associated with a terminal, including its storage facilities), other than a terminal situated within "a port or any approaches thereto" within the meaning of the Ports Act. (See sec.7(3)(a) of Decree No. 9 of 1969.)
6. The Convention of which Nigeria is a party was signed at Geneva on 29 April 1958. (See sec.11 of Decree No. 9 of 1969.)

(e) The Petroleum Profits Tax (Amendment) Decree (No. 22) 1970:

This Decree provides for the determination of the first accounting period and the extent of capital allowances due to an operating company under Part X of the Nigerian Companies Decree 1968 or a foreign-controlled company changing into a Nigerian control.

(f) The 1971 Model Contract:

Although this was merely a model contract, it provided a far-reaching amendment to the 1959 Petroleum Profits Act. It basically imposed OPEC conditions and increased "posted prices" and taxes on Nigerian operations. Although not an enactment, it had full force and effect because, among other reasons, it was signed between all Nigerian oil operators and the Federal Government.

(g) The Petroleum Profits Tax (Amendment) Decree (No. 15) 1973:

This Decree, among other things, defines the accounting period for a company engaged in petroleum operations as a period of one year commencing on 1 January and ending on 31 December of the same year. It also provides the time limit within which a tax return will be filed and taxes paid on an instalment basis. More specifically, it amends the 1959 Petroleum Profits Act to give effect to the agreement entered into with companies carrying on petroleum operations in Nigeria. Its effective date was 20 March 1971.

(h) The Petroleum Profits Tax (Amendment) Decree (No. 55) 1977:

This Decree amends the 1959 Act to effect changes in the percentage of the assessable tax payable in relation to the chargeable profits of the companies affected.

(i) The Petroleum Profits Tax (Amendment) Decree (No. 4) 1979:

This Decree simply amends section 1(2) of Decree No. 55 of 1977.

(j) The Petroleum Profits Tax (Amendment) Decree (No. 24) 1979:

This Decree amends the 1959 Act by giving certain incentives by way of reduced taxation to companies prospecting for oil in Nigeria. The decree took effect from 1 April 1977. Some of these incentives were, however, removed by Decree No. 95 of 1979.

(k) The Petroleum Profits Tax (Amendment) Decree (No. 95) 1979:

This Decree amends the 1959 Act to extend the effect of its provisions to companies engaged in liquified natural gas (LNG) operations.

III. IMPOSITION OF TAX AND ASCERTAINMENT OF PROFITS

A. Accounting period

A tax shall be charged, assessed, and payable upon profits of each accounting period of any company engaged in petroleum operations during any of the following accounting periods:[7]

(i) a period of one year commencing on 1 January and ending on 31 December of the same year; or
(ii) any shorter period commencing on the day the company first makes a sale or bulk disposal of chargeable oil[8] under a programme of continuous production and sales, domestic, export or both, and ending on 31 December of the same year; or
(iii) any period of less than a year being a period commencing on 1 January of any year and ending on the date in the same year when the company ceases to be engaged in petroleum operations.

B. Ascertainment of profit of an accounting period

The profit of a company in relation to any accounting period is the aggregate of the following:[9]

(i) the proceeds of sale of all chargeable oil sold by the company in that period,[10]
(ii) the value of all chargeable oil disposed of by the company in that period,
(iii) the value of all chargeable natural gas[11] in that period as determined in accordance with the fourth schedule, and
(iv) all income of the company of that period incidental to and arising from any one or more of its petroleum operations.

The value of any chargeable oil disposed of is taken to be the aggregate of the following:

(i) the value of that oil as determined, for the purpose of royalty, in accordance with the provisions of any enactment applicable thereto and any financial agreement or arrangement between the Federal Government of Nigeria and the company,[12]
(ii) any cost of extraction of that oil deducted in determining its value as referred to in (i) above, and
(iii) any cost incurred by the company in transportation and storage of that oil between the field of production and the place of its disposal.

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7. See sec. 2(a) of Decree No. 15 of 1973; see also sec. 9 of PPTA 1959.
8. "Chargeable Oil" in relation to a company engaged in petroleum operations, means casing head petroleum spirit and crude oil won or obtained by the company from such operations. (See Decree No. 95 of 1979.)
9. See sec. 9 of PPTA 1959.
10. New section 17A of Decree No. 1 of 1967.
11. "Natural gas" means gas obtained in Nigeria from boreholes and wells and consisting primarily of hydro-carbons. For this provision see section 2(a) of Decree No. 95 of 1979 amending section 9 of 1959 Act.
12. Sec. 2 of Decree No. 15 of 1973 amending sec. 9(a) of 1959 Act.

C. Computation of adjusted profit of an accounting period

(i) Deductions allowed[13]

In computing the adjusted profit of any company of any accounting period from its petroleum operations, there shall be deducted all outgoings and expenses wholly, exclusively and necessarily incurred, whether within or outside Nigeria, for the purpose of those operations during the period, and such outgoings and expenses include the following:

- rents (excluding rents included in the definition of royalties) and non-productive rents incurred in respect of land or buildings occupied for its petroleum operations or compensation incurred under an oil prospecting licence or mining lease for disturbance of surface rights or for any other like disturbances;
- all royalties, the liability for which was incurred by the company during that period in respect of crude oil exported from Nigeria (whether by the company or otherwise) or of casinghead petroleum spirit[14] so exported after injection into such crude oil;[15]
- all royalties, the liability for which was incurred by the company during that accounting period in respect of natural gas sold and actually delivered to the Nigeria National Petroleum Corporation (NNPC);[16]
- interest upon any money borrowed by a company if the Board is satisfied that the interest is payable on capital employed in carrying out the petroleum operations;[17]
- repair of premises, plant, machinery, or fixtures employed for the purpose of carrying on petroleum operations or for renewal, repair or alteration of any implement, utensils or article so employed;
- bad and doubtful debts;
- any expenditure including intangible drilling costs[18] incurred in connection with exploration, drilling, and the drilling of the first two appraisal wells in a particular field, including expenditure incurred in respect of cement and casing and well fixtures. Any expenditure deducted under this section shall not be treated as drilling expenditure for the purpose of capital allowances;
- any contributions to a pension, provident or other society, scheme, or fund approved by the Board with or without retrospective effect;
- all sums the liability for which was incurred by the company during that period to the Federal Government of Nigeria or to any State or local authority in Nigeria by way of duty (other than customs and excise duties deductible in ascertaining the tax under the provision of section 17), stamp duty, tax (other than the tax imposed by this Act), or any rate, impost, fee or other like charge; and
- such other deductions as may be prescribed by any rule made under Petroleum Profits Tax Act.

(ii) Deductions not allowed

In computing the adjusted profit of a petroleum company section 11 of the Act provides that no deduction shall be allowed in respect of the following:

- any disbursements, expenses, or liability not being money wholly, exclusively and necessarily laid out or expensed for the purpose of the operations;
- any capital withdrawn, or any sum employed or intended to be employed as capital;
- any amount employed in improvements as distinct from repairs;
- any sum recoverable under an insurance or contract of indemnity;
- rent of or cost of repairs to any premises or part thereof not incurred for the purpose of the operations;
- any amounts incurred in respect of any income tax, profits tax, or other similar tax within Nigeria or elsewhere;
- depreciation of any premises, buildings, structures, works of a permanent nature, plant, machinery, or fixtures;
- any payment to any provident, pension, savings, widows' and orphans' or other society scheme or fund not approved by the Board;
- any royalty or other sums deductible in ascertaining the tax under section 17 of the Act;
- any expenditure for the purchase of information relating to the existence and extent of petroleum deposits; and
- interest on borrowed money where such money was borrowed from a second company, if during that period –
  either company has an interest in the other company, or both have interest in another company either directly or through other companies, or
  both are subsidiaries of another company.

(iii) Exclusion of certain profits or losses

Section 12 of the Act provides that, where a petroleum company is also engaged in transportation of chargeable oil by means of ocean-going tankers, either operated by or on behalf of the company to any other

13. See section 10 of 1959 Act as amended.
14. "Casing head petroleum spirit" means any liquid hydro-carbons obtained in Nigeria from natural gas by separation or by any chemical or physical process, but before the same has been refined or otherwise treated.
15. Sec. 1(5)(aa) of Decree No. 1 of 1967 amending section 10(1) of 1959 Act.
16. Sec. 1(a) of Decree No. 95 of 1979.
17. Interest on loan from any of its subsidiary companies may not be allowable as deduction.
18. "Intangible drilling costs" means all expenditure for labour, fuel, repairs, maintenance, hauling and supplies and materials (not being supplies and materials for well cement casing or other well fixtures) which are for or incidental to drilling, cleaning, deepening of completing wells or the preparation thereof incurred in respect of: (a) determination of well locations, geological studies and topographical and geographical surveys preparatory to drilling, (b) drilling, shooting, testing and cleaning wells, (c) cleaning, draining and levelling land, road building and the laying of foundations, (d) erection of rigs and takage assembly and installation of pipelines and other equipment required in the preparation or drilling of wells producing petroleum. (See sec. 1(b) of Decree No. 15 of 1973.)

territory, any profit or loss attributable to such transportation business shall be excluded from the adjusted profits chargeable under the Act.

In addition to the exclusionary provision, section 13 of the Act authorises the Board to disregard any artificial or fictitious transaction[19] which reduces or would reduce the amount of any tax payable under the Act. Alternatively the Board may order any adjustments as to neutralise the effect of the artificial disposition on tax liability.

D. Ascertainment of assessable profit

Under section 14 of the Act, the assessable profit of any company for any accounting period shall be the amount of the computed adjusted profit for the period less the amount of any losses incurred by the company during any previous accounting period. The deduction of such losses shall be made as far as possible from the amount, if any, of the adjusted profit of the first accounting period after that in which the loss was incurred, and any balance carried forward to the next succeeding accounting period, until the full amount is extinguished.

The company may elect in writing within five months after the end of the accounting period that deduction of any loss or part thereof shall be deferred to and be made in the succeeding accounting period, and may so opt from time to time in a succeeding accounting period.

E. Chargeable profit calculation and capital allowances

(i) Calculation of chargeable profit

Under section 15 of the Act, the chargeable profit of any company for any accounting period shall be the amount of the assessable profit of that period less any capital allowances on qualifying capital expenditures granted in lieu of depreciation. The qualifying capital expenditures as provided under the second schedule to the Act are as follows:

(a) qualifying plant expenditure being capital expenditure incurred on plant, machinery, or fixtures;
(b) qualifying pipeline and storage expenditure being capital expenditure incurred on pipelines and storage tanks;
(c) qualifying building expenditure being capital expenditure incurred on the construction of buildings, structures, or works of a permanent nature; and
(d) qualifying drilling expenditure being capital expenditure incurred in connection with or with a view to petroleum operations on:
- the acquisition of, or of rights in or over, petroleum deposits,
- searching for or discovering and testing petroleum deposits or winning access thereto, or
- the construction of any works or building which are likely to be of little or no value when the petroleum operations for which they were constructed cease to be carried on.

The usual capital allowances granted under the second schedule are the initial allowances (which are in the form of investment tax credit) and the annual allowances. There could also be balancing allowances or charges which may arise when the asset is disposed of. The current rates[20] of the initial and annual allowances are as follows:

Table I
Initial allowances (Investment tax credit)

Qualifying expenditure in respect of	*Rate (%)*
On-share operations	5
Operations in territorial waters and continental shelf areas upto and including 100 metres of water depth	10
Operations in territorial waters and continental shelf areas in water depth between 100 and 200 metres	15
Operations in territorial waters and continental shelf areas beyond 200 metres of water depth	20

Table II
Annual allowances

	Rate (%)
First year	20
2nd year	20
3rd year	20
4th year	20
5th year	19
6th year and after	19

(ii) Limitations on capital allowances

In calculating the capital allowances, a limitation is imposed by section 15(3) and (4) to ensure that the amount of any tax chargeable on the company for that period shall not be less than 15% of the tax which would be chargeable if no deductions were to be made.

Furthermore, the aggregate amount of deductions allowable as capital allowances shall be either

(i) the full amount of capital allowances due, or
(ii) 85% of assessable profit less 170% of the total amount of the offsetable tax under section 17,
whichever is the less.

(iii) Deferment of capital allowances

Where, however, the total amount of capital allowances due cannot be deducted owing to insufficiency of, or no assessable profit, in an accounting period, or owing to the limitation imposed by section 15(3) and (4) discussed above, such total amount or part thereof which has not been so deducted shall be deferred and added to the aggregate amount of capital allowances for the following accounting period, and thereafter

19. A transaction may be artificial or fictitious if (i) it is between persons one of whom has control over the other, or (ii) it is between persons both of whom are controlled by some other person. (See sec. 13(2) of the Act.)
20. Section 5 of Decree No. 95 of 1979 amending paragraphs 5 and 6 and Tables I and II of the second schedule.

shall be deemed to be a capital allowance due to the company for that following accounting period.

F. Ascertainment of assessable tax and chargeable tax

(i) Assessable tax

Up to March 1971 the assessable tax for any accounting period was 50% of the chargeable profit, and it was 55% thereafter. But with effect from 1 April 1975 it rose to 85%.[21]

(ii) Chargeable tax and offsetable deductions

The chargeable tax for any accounting period of a company shall be the amount of its assessable tax for that period after the deduction of the following offsetable taxes allowed under section 17:

(a) all royalties due in respect of oil won and disposed of to local refinery during that period not being royalties deductible under section 10(1)(aa) in computing the adjusted profit;[22]
(b) all non-productive rents the liability of which was incurred by the company during that period;
(c) all sums the liability of which was incurred during the accounting period to the Federal Government of Nigeria by way of customs or excise duty or other like charges levied in respect of plant, storage tanks, pipelines, tools, machinery and equipment essential for use in the company's petroleum operations;[23]
(d) the amount of investment tax credit referred to in Table I above.[24]

The section specifically excludes any liability incurred in relation to any income or profit not chargeable to tax under the Act as well as liability incurred in relation to income excluded under section 12 in computing adjusted profit.[25]

Under subsection 4 of section 17, where the total offsetable deductions allowed exceed the assessable tax, or where there is no assessable tax for that period, such excess or such total amount shall be carried forward and deducted from future assessable taxes until it is completely deducted.

However, if for any accounting period, the amount of chargeable tax as computed under the Act is less than the sum obtained by multiplying the number of barrels of the crude oil sold by the "posted price" per barrel applicable to that crude oil, the company shall be liable to pay an additional amount of chargeable tax for that period, which is equal to the difference between those two amounts.[26]

(iii) Profile for ascertainment of profits and tax payable

From the discussions in Part III of this paper, the following represents the profile for arriving at the various concepts of profits and taxes for the purpose of the petroleum profits tax:

Amount of assessment	₦	₦
Gross Profit (or Proceeds) (section 9)	x	
Other Income	x	
Total Gross Profit		x
Less Expenses (section 10)		x
Adjusted Profit		x
Less Losses (section 14)		x
Assessable Profit		x
Less Capital Allowances (second schedule)		x
Chargeable profit		x
Assessable Tax at 85% of Chargeable Profit		x
Less Offsetable Allowances or Taxes (section 17)		x
Chargeable Tax		x
Less Tax already paid		x
Balance of Tax due		x

IV. ACCOUNTS, RETURNS AND ASSESSMENTS

A. Delivery of accounts, particulars and estimates

(i) Delivery of accounts and particulars

Section 24 of the Act provides that every company engaged in petroleum operations is required for each accounting period, within five months after the expiration of that period, to deliver to the Board a copy of its profit and loss accounts (certified by an auditor) arising from the petroleum operations, and also to prepare and deliver the following particulars:

(a) computations of its estimated adjusted profit or loss and of its estimated assessable profit of that period;
(b) a schedule showing:
  (i) the residues at the end of that period in respect of its assets,
  (ii) all qualifying petroleum expenditure incurred by it in that period,
  (iii) the values of any of its assets disposed of in that period, and
  (iv) the capital allowances due to it for that period;
(c) a computation of its estimated chargeable profit of that period;
(d) a statement of other sums deductible under section 17;
(e) a statement of all amounts repaid, refunded, waived, or released under section 17(5) during that period; and
(f) a computation of its estimated tax for that period.

21. Section 1(2) of Decree No. 55 of 1977.
22. Section 6(a) of Decree No. 15 of 1973.
23. Ibid., section 6(b).
24. Section 4(b) of Decree No. 95 of 1979.
25. See section 17(6) of the Act.
26. See new section 17A introduced into the 1959 Act by Decree No. 1 of 1967.

(ii) Return of estimated tax

In addition to the submission of the *ex post* estimated tax for the immediately expired period, every company engaged in petroleum operations is required to submit, not later than two months after the commencement of an accounting period, a return of estimated tax derived *ex ante* for the commenced period, subject to a revision of such a return being allowed, where necessary, during that period.[27]

B. Assessments and payments of tax

(i) Assessments

As soon as possible after the return and accounts of a company have been received, or soon after the expiration of the time allowed to such company for the delivery of the accounts and particulars, an assessment shall be made of the company in writing, indicating, among other things, its accounting period, the amount of its chargeable profits, assessable tax, chargeable tax, and the place at which payment of the tax should be made.

Where it is discovered that a company has not been charged tax or has been charged insufficient tax for any accounting period, an additional assessment may be made within six years after the expiration of that accounting period.

(ii) Payments of tax

Payments of petroleum profits tax for any accounting period of twelve months shall be payable in twelve equal instalments together with a final instalment which shall be due and payable within 21 days of the date of service of the notice of assessment.[28]

While the earlier instalments are based on the tax estimated to be chargeable for an accounting period in accordance with section 27, the final instalment shall be the amount assessed for that accounting period less so much thereof as has already been paid.

If any instalment of tax due and payable is not paid within the prescribed appropriate time limit under section 38, a penalty equal to 5% of the amount of the instalment due and payable shall be added thereto.

Where, however, a notice of an objection or an appeal has been given by a company, collection of the tax shall remain in abeyance until such objection or appeal is determined. The Board may, in such a case, enforce payment of any portion of the tax which is not in dispute.[29]

V. OTHER GENERAL PROVISIONS

A. Objections and appeals

Where a notice of assessment has been served on a company under section 32(1) of the Act, the company reserves the right under section 32(2) to object to the assessment by giving a notice of objection in writing to the Board within 21 days from the date of service of the assessment to review and revise such assessment on the grounds stated in the notice of objection. The notice of objection shall state the amount of chargeable profits of the company for the accounting period under review, together with the amount of assessable and chargeable taxes which the company considers desirable.

Any company being aggrieved by an assessment which has failed to reach a consensus with the Board on its notice of objection, has the right under sections 34 and 35 to appeal to the appropriate Body of Appeal Commissioners, the High Court, and the Federal Supreme Court, as the case may be.

An appeal to Appeal Commissioners shall be upon a notice in writing given to the Board and to the secretary to such Commissioners within 30 days, or such an extension of period not exceeding 60 days, after the date of service upon it of notice of refusal of the Board to amend the assessment as desired. The appeal shall be heard in camera.

A company aggrieved by the decision of Appeal Commissioners may appeal against the assessment and such decision to the High Court upon giving notice in writing to the Board within 30 days after the date upon which decision was given. The onus of proving that the assessment complained of is excessive shall be on the appellant. All appeals shall be heard in camera, unless the judge shall, on the application of the appellant, otherwise direct.

An appeal against the decision of the High Court shall lie to the Federal Supreme Court at the instance of either the appellant or the Board. Thereafter, assessment shall become final and conclusive, one way or the other.

B. Offences and penalties

A petroleum company may be guilty of any of the following offences under section 44 of the Act:

(i) failure to comply with the requirements of a notice served under the Act; or
(ii) failure to prepare and deliver accounts, particulars and returns; or
(iii) failure to attend, without sufficient cause, in answer to a notice or summons, or having attended, failure to answer any question lawfully put; or
(iv) failure to submit any return of estimated tax.

Any company guilty of any of these offences or of any rule made thereunder for which no penalty is specifically provided, shall be liable to a fine of ₦ 10,000.

For a failure to submit a return, or to deliver accounts,

27. See section 27 of the Act as amended by section 8 of Decree No. 15 of 1973.
28. See section 38 of the Act and the third schedule as introduced by section 9 of Decree No. 15 of 1973.
29. See section 37 of the Act.

particulars or information, or to keep records required, a further sum of ₦ 2,000 for each and every day during which such offence or failure continues and, in default of payment, imprisonment for six months, the liability for such further sum to commence from the day following the conviction, or from such day thereafter as the court may order.

Other offences which attract varying sanctions include making of incorrect accounts, particulars and returns, making of false statements and returns, offences by authorised and unauthorised persons.

Any offence under the Act shall be deemed to occur in Lagos.

VI. SUMMARY AND CONCLUSION

Taxation of petroleum profits in Nigeria is about two-and-a-half decades old. It has remained an important source of revenue for the country, the present oil glut notwithstanding. Its importance to the Nigerian economy is explained partly by the fact that it is under a separate tax law and partly by the fact that its tax law is under close surveillance by the Federal Government of Nigeria. In view of the latter it has undergone several surgical operations, by way of amendments, since it came into force in 1958. While the amendments are aimed at encouraging companies engaged in petroleum operations, they also ensure that appropriate taxes are collected by the Government as and when due.

In view of the international dimension and influence in petroleum operations in Nigeria, our petroleum profits tax system will continue to have far-reaching effect at both international and national levels.

[continued from 368]

Executive Committee

The Executive Committee of the Swiss Branch of IFA is, as of 13 June 1986, composed as follows:

Prof.Dr. J.M. Rivier, Lausanne (Chairman)
Dr. A. Burckhardt, Basel (Vice-Chairman)
Dr. k. Stocker, Zurich (Treasurer)
Dr. H.K. Lüscher, Zurich (Secretary)
Prof.Dr. P. Böckli, Basel
J.P. Chapuis, Basel
Dr. Th. Faist, Bern
Dr. H. Gunz, Lucerne
R. Lenz (attorney), Geneva
D. Metzger, Bern
P. Spori, Bern
Dr. M. Desax, Zurich

The following persons were nominated as members of the General Council of IFA as representatives for Switzerland:

Prof.Dr. J.M. Rivier and Dr. A. Burckhardt.

Their deputies are:

Dr. K. Stocker
Dr. H.K. Lüscher
Dr. H. Gunz
J.P. Chapuis

MALTA:

The Merchant Shipping Act, 1973 – Tax Concessions

By Edwin A. Vella

The Merchant Shipping Act, 1973 (MSA) does not bring into being a flag of convenience. This has been repeatedly emphasised during debates in Parliament, both when the MSA was originally introduced, and again during the debate on proposed amendments to the law.

Although the main purpose of the MSA is that of creating public revenue through registration under the Malta flag, Government has always been at pains to give a good image to the flag even though this could mean that revenue would not, especially in the initial years, be on the high side. Revenue is currently about $1m per annum. There are some 2 million tons of shipping registered under the Malta flag: this compares rather poorly with the performance of Cyprus which entered the ship registration market just a few years before Malta. There are various reasons why this is so, but taxation does not appear to be one.

The main tax law of the country (the Income Tax Act, 1948: ITA) grants the usual exemption to foreign shipowners on a reciprocal basis. This exemption, however, does not affect ships registered under the Maltese flag and owned by domestic companies, that is to say by companies themselves registered in Malta, irrespective of the country of residence of shareholders. It only exempts foreign shipowners from Malta tax on profits earned in Malta if the home territory of the shipowners grants an equivalent exemption to Maltese ships earning profits from the said territory. This exemption is shored up by the normal provisions regarding shipping which are found in all of Malta's double taxation agreements.[1]

As set out below, however, most of Malta's double taxation agreements comprise a special provision amending the normal OECD[2] rule in this regard. This is made necessary precisely by those provisions of the MSA which grant exemption from taxation.

The ITA contains no specific provision regarding domestic shipping, except to grant tax depreciation on the straight line basis instead of the normal reducing (declining) balance method. Part III of the MSA, however, introduces "concessions" in respect of taxation. Under this heading, the law grants exemption from income tax, death and donation duty, and duty on documents (stamp duty).

It is important to note that, in terms of section 85 of the MSA, exemptions can only be obtained by companies which are registered with the Minister of Finance for this purpose. These companies must be companies qualified to own a Maltese ship, that is to say, they must be companies registered in Malta.

Section 85 also introduces the concept of an "exempted ship". Primarily, an exempted ship is one which is registered with the Minister of Finance as such. The relevant conditions are that:

(a) the ship must be owned by a company or companies qualified to own a Maltese ship as above;
(b) the ship must be of not less than one thousand net tons;
(c) the ship must be engaged in the carriage of goods or passengers; and
(d) the registration fees in respect of the ship must have been duly paid.

Mr. Vella is co-correspondent for the Bulletin for Malta. He was educated at the Lyceum and the Royal University of Malta. Joined the Malta Civil Service in 1951, from which he retired with the rank of Assistant Commissioner of Inland Revenue in 1979. During his period of service at the Inland Revenue, Mr. Vella took a leading part in the negotiation of Malta's double taxation treaties as well as in the refashioning of the taxation laws of the country. He is at present tax consultant with Naudi, Giorgio, Leone Ganado & Co. who are the correspondent firm of Price Waterhouse in Malta. Mr. Vella lectures regularly on taxation and is an examiner in the subject both at the University of Malta and with the Malta Institute of Accountants. Mr. Vella is a well known author on taxation and two of his books have long been recognised as the standard text books on income tax and death duty in Malta.

1. Agreements with Finland, Sweden, Norway, Denmark, Germany, Belgium, the Netherlands, France, United States, United Kingdom, Italy, Austria, Libya, Pakistan and Australia.
2. Article 8 of the Model Double Taxation Convention on Income and on Capital: "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.

Where these conditions are satisfied, registration is automatically obtained by submitting to the Minister of Finance:

(i) the name of the company concerned;
(ii) its registered address; and
(iii) the name and tonnage of the ship it is desired to own or operate as an exempt ship.

An amendment to the law would enable the Minister responsible for shipping, acting with the concurrence of the Minister of Finance, to declare any ship to be an exempt ship: subject to such conditions as he may deem appropriate. This would be irrespective of tonnage, operation or trade. Here the administration is given discretionary powers since registration is not automatic, and no stipulations are set out within which the Minister may exercise the powers conferred upon him. The main result of this new provision would appear to be to enable exemption to be granted in appropriate cases where the ship in question is of less than one thousand net tons. Another application of the new provision would be to grant exemption to ships which are not engaged in the carriage of goods or passengers: e.g. fishing boats, survey vessels and other specialised ships.

The benefits contemplated by the MSA can accrue not only to an owner of an exempted ship, but also to an operator. The operation of a ship is defined as being not only its operation by the owner, but also its operation by a charterer. The charterer, however, must pay registration fees equal to and in addition to the annual registration fee payable by the owner.

The crucial exemptions from income tax are contained in section 86 of the MSA. The exemptions given are threefold and cover:

(a) that part of the income accruing to a company from the ownership or operation of an exempted ship;
(b) dividends paid out of gains or profits which are themselves exempt as at (a) above; and
(c) interest, etc., payable to any person resident outside Malta by a company registered for this purpose in respect of any loan or other debt due by it and incurred in acquiring the ownership of an exempted ship or for the purpose of the operation of an exempted ship while she was an exempted ship: but this exemption is denied if the recipient of the interest is himself engaged in trade or business in Malta through a permanent establishment situated therein, or if the tax authorities are not satisfied that the recipient is the beneficial owner thereof.

The exemption of profits from tax is conditioned on the maintenance of separate accounts distinguishing clearly between profits earned from an exempted ship and any other profits made by the company.

As regards dividends, the exemption is limited to the immediate shareholder of a company owning or operating an exempt ship. There are no provisions for exemption to be carried through from one company to another on the distribution of inter-company dividends, beyond the distribution by the owning or operating company to its immediate shareholder. On the other hand, there is no time limit within which such an exempt distribution can be made.

The rationale behind the conditions under which exemption on interest payable to non-residents of Malta may be denied, is not very clear. The link with the existence of a permanent establishment in Malta is clearly borrowed from the OECD Model Double Taxation Convention where a reduction of tax on interest in the country of origin is denied if the interest is linked with a permanent establishment situated therein. But, while this condition in a DTA is easily understandable, being intended to defeat any attempted conversion of business profits (taxable in full) into interest (taxable at a reduced rate), its insertion in the MSA seems to be out of place. The fact that the foreign provider of loans to a Maltese shipping company may also have a permanent trading establishment in the country appears to constitute no reason why the exemption otherwise applicable to the interest should be denied. There seems to be no way in which the profits of the separate trading establishment can be converted into exempt interest on the loan. In this regard, indeed, the MSA would appear to follow a line of reasoning that has been rejected by the OECD, namely the so-called force of attraction of the permanent establishments (P/E), whereby the mere existence of a P/E is sufficient to prevent a reduction of the tax chargeable in the country of origin of the interest, irrespective of whether the debt giving rise to the interest services the P/E or not.

The second condition, namely that the tax authorities must be satisfied that the interest is actually accruing to the benefit of the recipient, appears to be intended to provide against the possibility of a local person providing finance to a shipping company and trying to obtain exemption from tax on the interest by routing funds through a foreign entity. This possibility does exist, but it is remove in view of the stringent exchange control regulations of the country. The provision would therefore appear to be only a safeguard against the use of funds originating from the black economy for this purpose. If such funds are recognised for what they are, however, denial of tax exemption on the relative interest would be the least of the problems facing the owner!

The exemption from income tax granted under the MSA to shipping companies has had an unfortunate repercussion on Malta's double taxation agreements. As already noted, these are based on the OECD Model, but the rule contained in Article 8 of the Model has had to be amended in most of the DTAs because the shareholding of companies that potentially qualify for exemption is open to non-residents of Malta. A combination of the MSA exemption and the normal OECD rule could result in the flight to Malta of shipping from a country which is a party to a DTA with Malta: hoping to enjoy exemption from its former (and actual) territory under the DTA, and from Malta under the MSA. The combination could also adversely affect Malta's treaty partners if third country shipping, which is at present taxed by said treaty partner, were to be registered in Malta. In such a case exemption at both ends could be attempted (it is being assumed that in the home territory – i.e. the third country – of such shipping, no tax problems arise).

This situation has had to be provided for in the double taxation treaties to which Malta is a party by way of some provision such as the following which has been inserted in the U.S.A./Malta treaty:

> Notwithstanding the other provisions of this Article, profits from the operation of a ship in international traffic and gains from the sale, exchange or other alienation of such a ship, derived by a corporation resident in Malta which has more than 25% of its voting stock owned, directly or indirectly, by persons not resident in Malta, may be taxed by the United States unless the corporation proves that the profits derived from the operation of such ship are subject to Malta tax without regard to any relief therefrom as provided for in section 86 of the Merchant Shipping Act, 1973, or in any identical or similar provision.[3]

In all the agreements where this provision has been inserted, exemption under the DTA will be granted by the other country to Malta's shipping only if it is proved either:

(a) that the shareholding in the Malta company owned by persons not resident in Malta is less than 25%; or
(b) if more than 25% so controlled, the profits derived by any ship operated by the company are brought to tax regularly in Malta without any benefit such as is contemplated by the MSA.

It will be noted that exemption under the DTA will be denied to Maltese shipping by the U.S.A. not only if the relative Maltese company is controlled as to more than 25% by U.S.A. residents, but also if it is controlled in this proportion by persons resident elsewhere but in Malta. Malta's treaty partners are thus protected against losses that could be incurred through third country shipping, which is at present liable to tax therein, being registered in Malta.

The only treaties to which Malta is a party and in which this provision is not inserted, are those with the United Kingdom, Libya and Austria. The relative wording in the agreements is as follows:

United Kingdom: "... *profits which a resident of one of the territories derives from operating ships or aircraft shall be exempt from tax in the other territory*". Since it is usually the residence of companies which is involved, this is established in accordance with the normal rules regarding the place where effective management of the enterprise is exercised. These are the directors' meetings at which the really crucial trading decisions are hammered out. A meeting of local directors merely rubber stamping decisions taken elsewhere would not make a Malta registered company resident in the country for tax purposes. A name plate company in Malta may not therefore achieve exemption from the U.K. end, even though it may be exempt from Malta tax under the MSA.

Libya: "... *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*". This exemption is written in OECD terms which paraphrases the concept that a company is resident in the place where its effective management is exercised. In this sense, what is said above in respect of the U.K. agreement applies equally to the Libyan treaty. However, while the U.K. agreement does not limit the type of operation to which exemption applies, the Libyan treaty requires that operations be in international traffic which is defined in the OECD Model (though not in the Libya/Malta DTA itself) as consisting of transport by a ship or aircraft ... except when the ship or aircraft is operated solely between places in the other Contracting State.

Austria: The provision was apparently not a part of the Austrian agreement because Austria, being a landlocked nation, was not affected by this matter.

Part III of the MSA also grants exemption from death duty on shares in shipping companies. This provision, however, is to a great extent a dead letter, as one of the conditions to obtain exemption is that the deceased shareholders must be persons who are not ordinarily resident in Malta. Now while it can happen that shares in a Maltese shipping company are held directly by Maltese individuals, it would be rather exceptional to find such shares being held personally by a non-resident individual. As far as it is known, practically all shares in companies qualified to register for the purpose of the MSA tax concessions, are held by companies registered abroad.

The exemption granted from death duties is expressed to be total and not an exemption with progression. That is to say, not only the relative assets are exempt from duty, but they are also not to be taken into account in computing any duty that may be otherwise due.

The assets which qualify for exemption are shares in companies registered for the purpose of the MSA tax concessions, to the extent, however, that the value of such shares is attributable to:

(i) the value of an exempt ship or part thereof;
(ii) the proceeds of a sale of an exempted ship; and
(iii) other assets acquired directly out of the profits derived from the ownership or operation of an exempted ship or out of the proceeds of sale of such assets.

This exemption will only operate if accounts are produced to the tax authorities which show clearly over the years:

(i) what profits have been derived from the ownership

3. Article 8(5) of Legal Notice 61 of 1984, U.S.A./Malta DTA.

or operation of an exempt ship as distinct from profits earned in any other way;
(ii) the amounts from time to time spent by the company directly out of such profits on the acquisition of other assets and out of the proceeds of sale of such assets on the acquisition of further assets; and
(iii) the proceeds of sale of exempted ships.

The above method of determining which part of a share's value is to qualify for exemption is rather confusing. In the first place, it seems to put too much emphasis on the asset basis of share valuation. This is always an important element in share valuation, but the MSA practically elevates it to the status of the sole element to be taken into account. Secondly, tracing the movement of funds over the years in the way indicated is an almost impossible task, and is certainly something that does not usually emerge from accounts.

The overriding condition to achieve exemption from death duty is that the owner of the shares must be a non-resident of Malta. The actual exemption is expressed in narrower terms, because it is not only required that the shares owned by a deceased shareholder were held by non-resident persons, but also that *all* the shares and *all* the debentures in the relative company were held by a non-resident person and that, furthermore, *all* the shares and *all* the debentures in any company owning shares and debentures in the company the non-resident shareholder of which has died, were themselves also held by non-residents of Malta. It is curious that although a condition for exemption is that debentures in the relative company must also be held by non-residents, there is no exemption granted to debentures themselves even when these are owned by non-residents.

The last point which needs to be made regarding exemption from death duty is that, although in principle shipping companies whose shares qualify for exemption must be devoted solely to the business of owning or operating exempted ships, such a company will still be considered to be devoted wholly to this business notwithstanding that it has power to engage in and has engaged in operations incidental to the ownership or operation of exempted ships or the investment in other assets of the profit derived from such ownership or operation or the variation of such other assets, provided that the principal business of the company remains that of owning or operating exempted ships.

The final tax exemption given by the MSA is exemption from stamp duties, today called duties on documents. This duty is payable in terms of the Duty on Documents Act, 1981 on various instruments and the MSA grants exemption from duty on any instrument connected with or involving:

(a) registration of exempted ships, otherwise leviable as a transfer;
(b) the allotment of any newly issued shares of a company qualifying to register for the purpose of the tax exemptions granted by the MSA;
(c) the transfer of any stock or share of such companies; and
(d) the sale or transfer of an exempted ship or part thereof.

The MSA does not grant a blanket exemption from Stamp Duties to qualifying companies. Stamp duty is in general chargeable "ad valorem" on instruments concerned with the following matters:

- Transfer of immovables at 3.5%.
- Transfer of ships or aircraft at 2.6%.
- Transfer of goodwill, debts and other rights at 2.6%.
- Transfer of motor vehicles at 2.5% to 3%.
- Transfer of shares at 2%.
- Allotment of shares at 0.4%.
- Valuations and appraisements at 0.2%.
- Receipts at 0.05%.
- Insurance: life at 0.1%.
- Others at 0.03%.

These continue to be chargeable except in so far as exemption is granted by the MSA.

The taxation arrangements, or concessions as the MSA calls them, would appear to meet the requirements of what it sets out to achieve: namely that of increasing registration under the Malta flag as a means of increasing public revenue. The rather moderate success so far obtained appears to be due to other factors, mostly administrative in character, but of genuine concern in at least one aspect, namely the ranking given under Maltese law to mortgages on ships. With the bigger ships being financed to a major extent by banks, it seems reasonable to expect a higher ranking than at present obtainable. The exemption given to interest payable to non-residents is a step in the right direction, but this should now be backed by greater security for banks ready to finance ships registering under the Malta flag. This is in fact the major impediment to progress in the matter: other administrative difficulties are mostly caused by the simple fact that the Government, as a whole, does not appear ready to make an overall effort to direct the executive into a co-ordinated effort to meet the requirements of this highly specialised activity. Given this effort, there seems to be no reason why Malta, which geographically appears to be a natural candidate for success, should not achieve much better results than hitherto.

THAILAND:

Recent Tax Package to Boost the Economy

By Montri Hongskrailers and K.S. Jap

Mr. Montri Hongskrailers presently heads his own international law firm with a department specialized in international tax matters. Previously, he was associated with Coopers and Lybrand, Bangkok, Thailand. He is correspondent for the Bulletin for Thailand and is a regular contributor.
Mr. Jap is a principal research associate for the Bureau and provides special expertise concerning the Asian region.

INTRODUCTION

On 21 January 1986, the Thai Parliament approved a comprehensive tax package which aimed:
1. to bridge the revenue shortage;
2. to improve the take-home pay;
3. to boost the economy by reducing the corporate income tax and the individual income tax rates;
4. to prevent tax evasion; and
5. to give taxpayers the chance to correct filing tax returns by giving them "amnesty" treatment.

The main purpose behind reducing income tax rates is the belief that revenue will increase as the incentive for tax evasion decreases. This issue has long been debated. Moreover, it is argued that it will help relieve some of the tax burden prevalent under the present economic conditions, besides stimulating investments and expansion of businesses in the private sector.

The tax package was incorporated in the Emergency Decree Amending the Revenue Code (No. 14) 1986, effective as from 1 February 1986, which revised many provisions of the Thai Revenue Code 1938, as amended.

The changes covered most parts of the Revenue Code pertaining to individual income tax, corporate income tax, business tax and stamp duty.

Implementing regulations to the tax package are incorporated in the following regulations:
- Royal Decree No. 165 (1986) on deductible expenses for sales of immovable property by private persons;
- Royal Decree No. 166 (1986) on tax exemption of interest income earned by cooperatives;
- Royal Decree No. 167 (1986) on tax exemption of dividends from listed companies and mutual funds;
- Royal Decree No. 168 (1986) on the rate of income tax of certain income of foundations and associations;
- Royal Decree No. 169 (1986) on amendments of Royal Decree No. 54 (1974) on the rates of business tax;
- Ministerial Regulation No. 169 (1986) on tax exemption of interest on government bonds and income from securities sale.

Some of the salient features of the recent tax package are given hereafter.

CORPORATE INCOME TAX: JURIDICAL COMPANIES OR PARTNERSHIPS

A new definition of "juridical company or partnership" has been added. The Director-General of the Revenue Department is empowered, after the approval by the Minister of Finance, to announce in the Government Gazette certain entities as "juridical company or partnership" under the Revenue Code. Those entities are then subject to the corporate income tax.

The aim is to plug a loophole and to provide greater fairness to taxpayers belonging to other categories.

REDUCTION OF THE CORPORATE INCOME TAX RATE

The corporate income tax rate for companies and juridical partnerships not listed on the Securities Exchange of Thailand has been reduced from 40% to 35% as from 1 January 1986. The rate on the taxable profits for listed companies and juridical partnerships remains at 30%.

One of the reasons of reducing the rate is to keep the tax rate near to those prevailing in the neighbouring countries. This will in a way help stimulate investment in Thailand.

INTERCORPORATE DIVIDENDS

The dividends received by a company organized under Thai law from another Thai company organized under Thai law are exempt from corporate income tax for as much as 50% of the dividends received if the recipient company is not listed on the Securities Exchange of Thailand. If the recipient company is listed, the dividends received are completely exempt from corporate income tax. However, in both cases the total amount of the dividends received from Thai companies may not exceed 15% of the total gross profit of the recipient company in a tax year in order to qualify for the dividend exemption. No shareholding period was required before. At present, an amendment has been made to grant dividend exemption only if the period of ownership of the shares is not less than 3 months before the date of receipt of such dividends and, if the shares are sold, the period must at least be 3 months from the receipt of the dividends.

The goal of the amendment is to promote long-term investment in Thai companies and to prevent disposal of shares with the intent to evade corporate income tax.

INCREASE OF CORPORATE INCOME TAX RATES FOR NON-PROFIT ORGANIZATIONS

The corporate income tax rate on income derived by non-profit foundations or associations with respect to dividends, interest, rentals, royalties, professional fees, copyrights, and goodwill has been increased from 5% to 10% of the gross income. The corporate income tax rate on income from business, commerce, industry and transportation has been increased from 1% to 2% of the gross income.

The changes were made in order to be more consistent with the corporate income tax rates in other categories of income. Registration fees, membership fees, and donations received by foundations from their members remain to be exempt from corporate income tax.

INDIVIDUAL INCOME TAX: REVISED INDIVIDUAL INCOME TAX RATES SCHEDULE

The revised schedule of the individual income tax rates reduced the number of rate brackets from 13 to 11. The maximum income tax rate has been reduced from 65% to 55%. The revised schedule applies to income received on or after 1 January 1986. The reduction of the individual income tax burden is made with the aim to keep more in line with those prevailing in neighbouring countries.

PROGRESSIVE INDIVIDUAL INCOME TAX RATES

Taxable income (in baht)	*Tax rate (%)*
1 – 40,000	7
40,001 – 90,000	10
90,001 – 150,000	15
150,001 – 220,000	20
220,001 – 300,000	25
300,001 – 400,000	30
400,001 – 550,000	35
550,001 – 750,000	40
750,001 – 1,000,000	45
1,000,001 – 2,000,000	50
more than 2,000,000	55

TAXATION OF SHARE OF PROFITS FROM NON-JURIDICAL PARTNERSHIPS

Exemption from individual income tax on dividends or a share of profits from an ordinary partnership or "group of persons" which is not a juridical person received by an individual person shall be exempt in respect of the share of profit received in the year 1986 and onwards only if the paying partnership or "group of persons" has paid income tax on its profits. Prior to this charge the share of profits paid to individual partners were unconditionally exempt from individual income tax. The aim of the amendment is to plug the loophole.

THE CREDIT FOR DIVIDENDS RECEIVED

The tax credit on dividends received by an individual private shareholder resident in Thailand from a company or juridical partnership incorporated in Thailand is reduced from 35% to 30% of the dividends or the share of profit received from the company or juridical partnership. The revision is made in line with the reduction of the corporate income tax.

INTEREST EXEMPT FROM INDIVIDUAL INCOME TAX

Exempt from individual income tax are: interest on savings lotteries; interest on savings deposits with the Government; interest on time deposits with banks in Thailand; and interest on time deposits with cooperatives, but only to the extent to which that portion of the interest does not exceed 8.5% per annum as prescribed by the Bank of Thailand.

TAX ON INTEREST

As from 1 February 1986, the withholding tax of the individual income tax on interest received in the years 1986 to 1988 has been increased from 12.5% (1982 to 1985) to 15%.

The payer of the interest must withhold income tax at the rate of 15% on the following interests:

(1) interest earned from government bonds or debentures,
(2) interest on savings deposits with cooperatives,
(3) interest on other types of deposits regardless of description, but only the portion which exceeds the maximum rate of interest on savings deposits prescribed by the Bank of Thailand (i.e. 8.5% per annum),
(4) interest from bank deposits if the interest is more than 8.5% per annum,
(5) interest from deposits with cooperatives,
(6) interest from loans of financial companies and other financial institutions established by the law of Thailand to lend money for the promotion of agriculture, commerce or industry, and
(7) interest on promissory notes issued by finance companies.

If the interest is received in 1989 or later the progressive individual income tax rates are to be levied.

The main purpose to increase the proportional individual income tax rate is to lessen any impact on the deposits and savings which may arise in Thailand after 1986.

In addition, it is for greater fairness in the distribution of income among the people. Besides, a higher tax on interest will raise revenue and it is easily collected as the tax is withheld by the commercial bank.

GAINS FROM THE SALE OF BONDS

As from 2 February 1986 gains from the sale of bonds listed on the Securities Exchange of Thailand are subject to the individual income tax (prior to that date exempted) at the following rates:

(a) certain government bonds	15% on the gain from the sale of the bond that exceeds a return of 8.5% per annum
(b) bonds or debentures of State organizations or enterprises	15%
(c) bonds or debentures issued by the private sector	progressive individual income tax rates ranging from 7% to 55%.

The taxpayer may, during the years 1986 to 1988 with respect to gains under (a) and (b), elect to pay tax at the rate of 15% exclusive of any other income.

The taxation of the gains from the sale of bonds was designed to prevent tax evasion.

MORTGAGE INTEREST DEDUCTIBLE

A new deductible allowance for computing the individual income tax has been introduced as from 1986 with respect to mortgage interest paid not exceeding 7,000 baht per year. Any interest paid by an individual taxpayer to a bank or other financial institution, life insurance company, co-operative, or employer arising from a loan used to buy in cash, on hire-purchase, or to construct the taxpayer's residence by mortgaging the building purchased or for construction of the same as a collateral against the said loan qualifies as a deductible mortgage interest. The said building also includes the land.

This new deductible allowance aims to promote social welfare, to encourage private home ownership among low and medium income earners, as well as to stimulate the expansion of the construction industry in Thailand.

SALE OF IMMOVABLE PROPERTY BY PRIVATE INDIVIDUALS

The lump sum, deductible expenses used in computing the taxable income derived from the sale of immovable property acquired without a commercial purpose has been reduced from rates between 51% to 93% (depending on the number of years of ownership) to rates between 50% to 92% of the income. In addition, the maximum rate of the individual income tax has been increased from 10% to 20% of the sales price in case the taxpayer chooses to pay tax thereon separated from his other income. The charges apply to such income received from 1 February 1986.

The changes do not aim to increase the taxation of capital gains from the sale of immovable property, but they are rather an adjustment to the reduced normal individual income tax rates effective as from 1 January 1986.

The lump sum expenses used in computing taxable income derived from the sale of immovable property acquired by bequest or gift remain at 50% of the income. The maximum rate of 20% of the sales price also applies at the option of the taxpayer.

The itemized expenses are also allowed should the taxpayer think he has more expenses than the standard expenses allowed by law.

BUSINESS TAX ON LEASING BUSINESS

As from 1 February 1986, the business tax (sales tax on certain business transactions) on leasing businesses has been separated from other rental businesses. The rate of business tax for rental businesses will remain at 2.5% of gross receipts, but for financial leasing businesses the rate is 3% on the portion of income exceeding the costs. The aim of the change is to assist the financial leasing businesses (including operational leases) by excluding the repayment of the principal costs from the taxable base where normally business tax on interest-base income is paid.

DISCOURAGEMENT OF DIESEL OIL CONSUMPTION

To discourage the consumption of diesel oil in Thailand, the business tax rate thereon has been increased as from 2 February 1986:

- on the sale of imported diesel engines (except if used for fishing boats) from 5% to 9% of gross receipts; and
- on diesel car engines, with a seating capacity of not more than 10 persons, from 30% to 40% of the gross receipt in case of locally produced cars, and from 40% to 50% in case of imported cars (Royal Decree No. 169 of 1986).

Further measures to discourage the modification of petrol engines for use with diesel oil include the fourfold increase of the registration fees for motorcars using diesel oil or LPG, except for those used as taxis and buses of the Bangkok Mass Transit Organization (BMTO) (Motorcar Act 1979, as amended).

STAMP DUTIES

The stamp duty on loans or bank overdraft agreements which was formerly to be affixed at the rate of 1 baht for every 2,000 baht of a loan or bank overdraft without any ceiling, has now been set at the same rate to a maximum 10,000 baht as from 2 February 1986. The aim of this is to promote borrowings within and outside Thailand. In addition, the stamp duty previously affixed to all government forms is abolished.

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FOR FURTHER INFORMATION PLEASE WRITE TO:

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

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Legal Studies & Services Ltd., IBC House, Canada Road, Byfleet, Weybridge, Surrey KT 14 7JL. United Kingdom.

Management Centre Europe. The Registrar, rue Caroly 15, B-1040 Brussels, Belgium.

Taxation Institute of Australia, 7th Floor, 64 Castlereagh Street, Sydney, N.S.W. 2000, Australia.

ERRATUM

In the April/May 1986 issue, at page 163, Mr. Montri Hongskrailers is erroneously referred to as a member of Coopers & Lybrand, Bangkok.
Mr. Hongskrailers is head of his own offices in Bangkok.

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  I, release 317
- Algemene wetgeving
  release 235

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C. van Soest - A. Meering

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releases 9, 10
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CUMULATIVE INDEX 1986 – Nos. 1-7

I. ARTICLES:

II. REPORTS AND DOCUMENTS

III. IFA NEWS

IV. CONFERENCE DIARY

V. BIBLIOGRAPHY


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Contents

of the October 1986 issue

SOMMAIRE

INHALTSVERZEICHNIS

USA:

Competent Authority

By Sanford H. Goldberg*

I. INTRODUCTION

The rise of international trade and investment increases the risk of inconsistent treatment of international transactions. As each country has improved its knowledge of transnational economic affairs, as well as increased its need for revenue, the taxpayer and his advisors must learn to cope with the conflict among the tax enforcement positions of more and more countries.[1]

In the United States the impetus started with the Revenue Act of 1962 with its emphasis on overseas income and investments of U.S. corporations.[2] The reporting of transactions and investments to the IRS was increased soon thereafter[3] and pursuant to Congressional mandate the regulations on the allocation of income between related persons were dramatically strengthened.[4]

After approximately twenty years of increased audits of U.S. multinationals, the U.S. has now focused on foreign multinationals.[5] The Tax Equity and Fiscal Responsibility Act of 1982 introduced income reporting requirements for U.S. corporations controlled by foreign entities.[6] The forms for reporting intercompany transactions with controlling foreign interests or their affiliates were finalized in November, 1985.[7]

Although the U.S. is in the forefront of investigating its own multinationals and more recently foreign multinationals, it is not alone. The OECD published its analysis of transnational pricing problems in 1979.[8] The effect of the publication has reportedly been a significant increase in the tax audit of European corporations. As will be noted later, this development may have salutary repercussions for U.S. multinationals as the U.S. competent authority receives more ammunition necessary for trading purposes.

This article deals with the treaty mechanism for solving or ameliorating the conflicts that may arise.

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* Mr. Goldberg is a partner of Roberts and Holland of New York.
1. I wish to express my appreciation to the foreign and domestic tax practitioners who shared their experiences with me.
2. Pub. Law 87-834, particularly adoption of IRC §§951-972, 1246-1248.
3. IRC §§6038, 6046, Treas. Forms 959, 2952 and 3646 (now Treas. Form 5471). All citations are to the Internal Revenue Code of 1954, as amended, unless otherwise indicated.
4. H. Rep. No. 2508, 87th Cong., 2d Sess. at 4444, Reg. §1.482.
5. E.g. *U.S. v. Toyota Motor Corporation*, 561 F. Supp. 354 (C.D. Cal. 1983).
6. IRC §6038A.
7. Treas. Form 5472.
8. Transfer Pricing and Multinational Enterprises Report of the OECD Committee on Fiscal Affairs, 1979.

Table of Contents

II. THE TREATY MECHANISM

The method adopted by most developed and some developing countries to resolve these inter-country difficulties is the mutual agreement procedure enacted as part of a bilateral tax treaty. Thirty-four U.S. income tax treaties in force and 14 U.S. estate and gift tax treaties in force contain a mutual agreement procedure. The exception is the treaty with Ireland.[9] This article uses the U.S. Model Income Tax Treaty published in 1981 as its point of reference.

A. The U.S. Model Income Tax Treaty

Article 25 is as follows:

Article 25
Mutual Agreement Procedure

1. Where a person considers that the actions of one or both of the Contracting States result or will result for him in taxation not in accordance with the provisions of this Convention, he may, irrespective of the remedies provided by the domestic law of those States, present his case to the competent authority of the Contracting States of which he is a resident or national.

2. The competent authority shall endeavor, if the objection appears to it to be justified and if it is not itself able to arrive at a satisfactory solution, to resolve the case by mutual agreement with the competent authority of the other Contracting State, with a view to the avoidance of taxation which is not in accordance with the Convention. Any agreement reached shall be implemented notwithstanding any time limits in the domestic law of the Contracting States.

3. The competent authorities of the Contracting States shall endeavor to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the Convention. In particular the competent authorities of the Contracting States may agree:
(a) to the same attribution of income, deductions, credits, or allowances of an enterprise of a Contracting State to its permanent establishment situated in the other Contracting State;
(b) to the same allocation of income, deductions, credits, or allowances between persons;
(c) to the same characterization of particular items of income;
(d) to the same application of source rules with respect to particular items of income;
(e) to a common meaning of a term;
(f) to increase in any specific amounts referred to in the Convention to reflect economic or monetary developments; and
(g) to the application of the provisions of domestic law regarding penalties, fines and interest in a manner consistent with the purposes of the Convention.
They may also consult together for the elimination of double taxation in cases not provided for in the Convention.

4. The competent authorities of the Contracting States may communicate with each other directly for the purpose of reaching an agreement in the sense of the preceding paragraphs."

In addition to the extensive treatment of the mutual agreement procedure under Article 25, the 1981 U.S. Model Treaty, as well as existing U.S. treaties, contain other provisions relevant to the mutual agreement procedure.

1. Article 3(2) states that any term not defined in the treaty shall, unless the context otherwise requires or the competent authorities agree to a common meaning pursuant to the provisions of Article 25, have the meaning which it has under the internal tax law of the country applying the treaty.

2. Article 4(4) provides that where a person other than an individual or corporation is a resident of both countries, the competent authorities "shall settle the question by mutual agreement and determine the mode of application of the Convention to such person." The language is mandatory. Typically, it applies to estates and trusts.

3. Article 4(2)(d) provides that where the tie-breaking rules do not resolve the question of dual residency, "the competent authorities of the Contracting States shall settle the question by mutual agreement." This and Art. 4(4) are the few provisions where the competent authorities are directed to reach a conclusion.

4. Article 9(2) permits the competent authorities to consult each other where there is a disagreement as to the allocation of income or deductions among related parties.

5. Article 2(2) requires the competent authorities to notify each other of any changes in their respective tax laws and any official published material concerning the application of the treaty, including explanations, regulations, rulings or judicial decisions.

While each treaty may have its peculiar problems resulting from its specific text, there are many common practical problems that tax executives must know in order to advise their corporations. This article is written in two segments.[10] First, it deals with the practical problems that the author and practitioners world-wide have encountered and, second, it deals with the U.S. procedural aspects of invoking the mutual agreement provisions.

B. Specific case provisions

Paragraphs 1 and 2 of Article 25 are addressed to the problems of a specific taxpayer who believes that the actions of a state presently result or will result in taxation not in accordance with the Convention. The article is invoked by the action of a resident (or national) with respect to a specific situation. In the past the

9. There is no explanation in the legislative history for the absence of a mutual agreement procedure in either the income tax convention with Ireland or the estate and gift tax convention with Ireland. Most of the legislative history deals with the reason that the Irish treaty is so closely modeled after the U.K. treaty that the absence of a mutual agreement provision is intriguing.
10. A lengthier article including the U.S. legislative history of the mutual agreement provisions, comparison with the OECD Model Treaty and the U.S. Model Treaty was written for the Tax Club by the author.

majority of the cases covered by these paragraphs in the U.S. have involved the reallocation of income. (They are referred to, appropriately enough, by the Internal Revenue Service as "allocation cases".) Today, however, approximately one half of the U.S. cases involve interpretation and application of the treaty, e.g. the existence of a permanent establishment and the right to withhold taxes. (Referred to by the IRS as "non-allocation" cases.) Since these cases will ultimately reflect a negotiated settlement of a specific situation generally involving a tax return, it appears that they are not required to be published.[11] In any event, they are not published and taxpayers become aware of them as a result only of their mention in litigated cases or by discussions with other taxpayers, much in the same manner as the situation that existed prior to the publication of private letter rulings and technical advice memorandums.

1. Technical and practical problems

a. *Duty to consult, not agree*

Sections 1 and 2 of Article 25 provide that the competent authorities shall endeavor to agree to a consistent treatment of a transaction or interpretation of a provision. In an allocation case the objective sought is a correlative adjustment. The provision does not require agreement; it only requires a good faith effort by both competent authorities. Thus, the taxpayer may find that at the end of a long road the invocation of the mutual agreement procedure does not avoid economic double taxation. For example, in *Pierre Boulez v. Commissioner*, 83 T.C. 584 (1984) the court refers to a failure of the competent authorities of the United States and the Federal Republic of Germany to agree on the taxation of "royalties" paid to conductor Pierre Boulez for recording performances in the United States but measured by sales of records in Germany. The United States considered the payments as compensation for services performed in the United States and therefore subject to U.S. tax under Article X while Germany considered them royalties taxable exclusively by Germany under Article VIII of the German treaty. (Subsequent to the U.S. tax court decision, it is understood that Germany allowed a credit for U.S. taxes.)

b. *Duration of proceeding*

Almost every practitioner who has been involved in a mutual agreement procedure has expressed dissatisfaction with the length of time necessary for its completion. Examples have been given to me of cases that have taken more than seven years and are still not completed. The U.S. competent authority admits to a two-year average duration from request to completion.[12] U.S. practitioners have complained about the foreign competent authorities. Foreign practitioners have stated that the U.S. processing seems to take incredibly long. The length of time results in additional interest costs, either on the additional taxes or on the refund, large legal expenses, and a time-consuming expenditure of taxpayer manpower. This problem is not limited to the United States; foreign competent authority negotiations have the same problems. A recent French–Italian procedure lasted for years with the resultant reallocation being very small; some say less than the professional fees incurred. It is the major complaint against the mutual agreement procedure. Coupled with the lack of assurance of a satisfactory agreement, it is little wonder that some taxpayers consider this procedure as a last resort, when all other solutions fail.

c. *Double taxation*

Many U.S. treaties patterned after the 1963 OECD Model permit a resident to request the assistance of a competent authority only to avoid double taxation. One interpretation of this language requires double taxation of the same entity before the treaty can be invoked, referred to as juridical double taxation, i.e. the taxation by two countries of the same income in the hands of the same juridical person, for example, the allocation of income between the home office and a foreign permanent establishment. This permits the invocation of the mutual agreement procedure in a limited number of cases. The position has been taken by a number of U.S. treaty partners, e.g. Italy under the prior U.S.–Italian income tax conventions. A broader interpretation of the requirement includes economic double taxation; the only requirement is that two related parties economically bear the consequences of the additional tax and they are residents of two treaty countries. Typically, this would be a parent company selling to its subsidiary. Note that the specific case does not cover the reallocation where there is a third party interposed between the two countries. For example, if Daimler Benz were to sell an automobile to a Bahamian corporation which then resold it to a U.S. importing subsidiary and either Germany or the U.S., or possibly both, reallocated the purchase price, the transfer price on both sales would not be covered by the mutual agreement procedure.

There are other situations that should be covered by the procedure but do not result in double taxation. One country may not impose a tax because of an exemption provided under domestic law, e.g. the participation privilege in the Netherlands. Another situation is where there is a loss in one country that results in no current double taxation. (The U.S. will accept a loss case; some other countries will not.) A third situation is where the increased tax is offset by a foreign tax credit, as in the U.S. It is probably because of these situations that the 1977 OECD Model and the U.S. Model now use the phrase "taxation not in accordance with the provisions of this Convention," although this too could be limited to situations of double taxation on the theory that the elimination of double taxation

11. 5 USCA §552(b)(3); IRC §6103. "These closing agreements constitute confidential taxpayer return information, and the substantive terms and the legal basis of these agreements have not been made public in the form of revenue rulings or revenue procedures." Senate Executive Report No. 95-18, 95th Cong., 2d Sess. at 17 (1978). See also H. Rep. No. 94-658, 94th Cong., 1st Sess. at 316.
12. See Exhibit A.

is the goal of the treaty. The U.S. and most of its treaty partners interpret this provision to cover more than double taxation; but it is probably the reason that the U.S. Model specifically lists situations covered by the mutual agreement procedure. All but four of the U.S. treaties signed after 1967 list the situations suitable for the mutual agreement procedure.

Where the U.S. competent authority knows that the foreign position is to limit the treaty to juridical double taxation, they will give the taxpayer a letter that it is not necessary to pursue the mutual agreement procedure in order to avoid the loss of the foreign tax credit. Treasury regulations state that failure to use the mutual agreement procedure may result in a loss of the foreign tax credit.[13]

d. *Statute of limitations*

The U.S. Model,[14] most of the recent U.S. treaties and the OECD Model state that "Any agreement reached shall be implemented notwithstanding any time limits in the domestic law of the Contracting States." Canada, Greece, Ireland, Italy, Portugal, Spain and the United Kingdom have entered reservations to the inclusion of this sentence in their treaties. It is because the treaty does not override the domestic statute of limitations in many countries that the standard form letter that is now issued by the IRS in connection with section 482 reallocation cases warns the taxpayer that it should consider keeping open the statute of limitations in the other countries.

For example, in Japan in order to preserve a right to claim a refund of taxes, it is necessary to commence suit against the Japanese Government before the statute of limitations runs on the claim for refund. There is no way to toll the statute of limitations other than by bringing suit. In one case the Japanese Government opposed a suspension of the court proceeding pending the competent authority negotiations. It insisted on proceeding immediately, regardless of the competent authority negotiations. As a result the court refused the taxpayer's request for a suspension, although it did slow up the proceedings a bit. The competent authority determination was reached before the court determination and the case was dismissed.

The new Canadian treaty provides that where an adjustment is made, or to be made by one country, the other country shall, notwithstanding any time or procedural limitation in its domestic law, grant relief where the request for mutual agreement procedure is made within six years from the end of the taxable year to which the case relates.[15] Where the case involves adjustment of income between related parties, the country initiating the adjustment must do so within five and one half years from the end of the taxable year to which the adjustment relates.[16] The six-year rule does not apply in the case of fraud, willful default or neglect or gross negligence.[17]

e. *Incongruous income tax systems*

Not all situations of multiple taxation of the same items are dealt with by the treaties. The mutual agreement procedure applies where the action of the tax authorities results "in taxation contrary to the provisions of this convention." Thus, a provision in the convention must be applicable. An example of double taxation that is not covered by the mutual agreement procedure is Rev. Rul. 54-53, considering whether alimony paid from a trust in the United States by the former husband, a resident of the United States, to his former wife, an alien resident in Sweden, was taxable by the United States. The Swedish treaty has no provision dealing expressly with alimony. Moreover, the Swedish treaty does not include a provision comparable to Article 21 of the 1977 OECD Model and the U.S. Model Treaties that exempts from taxation income of a resident of the other state that is not covered by the treaty. Accordingly, the United States imposed the 30% withholding tax required by the Code. Under Sweden's internal law, Sweden also taxed the alimony to the former wife on the basis of her residence in Sweden without allowing a credit for the U.S. withholding tax. The ruling holds that the specific case provision of the Swedish treaty was inapplicable, stating: "Further, Article XX of the Convention provides in part that where action of the competent authorities of the United States and Sweden has resulted or may result in taxation in respect of any taxes to which the Convention relates, the competent authorities may agree to an equitable avoidance of double taxation. However, such article does not refer to a case where the reason for the double taxation of income is due to the difference in the systems of taxation in the two countries."[18]

Another example of the problem is found in Rev. Rul. 56-251[19] involving the estate tax convention between the United States and France. The ruling holds that the credit authorized by Article 5(2) of the French estate tax convention to the estate of a citizen of the United States domiciled in France at the time of his death does not apply where the French tax was imposed on shares of stock of corporations organized in countries other than the United States and France. Article 14 of the estate tax convention between the United States and France provided for a specific case use of the mutual agreement provision, as follows: "Any taxpayer who shows proof that the action of the revenue authorities of the Contracting States has resulted in double taxation in his case in respect of any of the taxes to which the present Convention . . . relates shall be entitled to lodge a claim with the state of which he is a citizen . . . ." Should the claim be upheld, "the competent authority of each state may come to an agreement with the competent authority of the other state with a view to equitable avoidance of the double taxation in question."

The competent authorities did not resolve the situation

13. Reg. §1.901(e)(5).
14. Paragraph 2 of Article 25.
15. Canada, Art. XXVI(2) and Art. IX(3).
16. Canada, Art. IX(4).
17. Canada, Art. IX(5).
18. Rev. Rul. 54-53, 1954-1 C.B. 156.
19. 1956-1 C.B. 846.

of double taxation. The ruling states that "in order to obtain relief under Article 14 of the Convention, it is essential that the taxpayer show proof that action of the revenue authorities of one of the Contracting States has resulted in double taxation *contrary to the provisions of the Convention.* Any other interpretation would render meaningless and in effect nullify specific provisions of the Convention such as those pertaining to situs of property and allowance of credit." Whether such interpretation of the Convention fulfils its intent depends upon whether the interpretor has an expansive view of the interpretation or application of the Convention or a less expansive literal interpretation of the grant of statutory authority.

Another example where the mutual agreement provision would be inapplicable would be state and local taxes. With the exception of the nondiscrimination provision, the United States treaties do not cover taxes imposed by the states of the United States. Accordingly, the competent authority provisions would not be available. Even where the competent authority might be applicable, such as a tax contrary to the nondiscrimination provision, it is unlikely that the United States competent authority by itself would have the power to reduce the taxes. The remedy in such case would have to be in court. The same problem previously existed with some of the Canadian provinces, but this is now ironed out and is no longer a problem.

f. *Repatriation*

An adjustment of an allocation case will frequently result in the funds ending up in the wrong country, i.e. one company has conferred a benefit on the alternate company in the other jurisdiction. Repatriation of a reallocation of income or deduction without tax can be made if the competent authorities agree. Under Rev. Proc. 65-17,[20] the Internal Revenue Service will allow the repatriation of the funds without an additional tax. If repatriation is not made, the additional funds will be treated as a dividend or as a loan, as the case may be. If funds will be repatriated from the United States to a foreign country, Rev. Proc. 65-17 will treat them as a payment of an account receivable not subject to U.S. federal income tax withholding. The situation is not always the same in other countries.[21] The extent of the relief is discretionary with the competent authority.[22] If a closing agreement is not part of the settlement, the details concerning repatriation will be stated in the Disposition Memorandum.[23] The right to repatriate should be raised as early as possible to insure its consideration by the competent authorities. In *Schering Corp.*,[24] the taxpayer ended up with two problems because the issue had not been settled by the competent authorities. First, Switzerland imposed a withholding tax on the repatriation of the overallocation, treating it as a dividend. Second, the U.S., which had granted an exemption for the payment under Rev. Proc. 65-17 relief, attempted to disallow the foreign tax credit on the payment.

The taxpayer should include in the protest a statement that he has requested mutual agreement assistance, that agreement of those issues is tentative, and that the taxpayer preserves his right to appeal the competent authority issues if it is unsuccessful.[25]

g. *Currency fluctuations*

Settlements reached by the competent authorities frequently involve the repatriation of funds between the two countries. The repatriation will be made in whichever currency was the currency of the original transaction.[26] This may result in exchange gain or exchange loss realized from the difference in the currency exchange rates between the date the original transaction took place and the date of the repatriation. For example, the Canadian Government takes the position that when adjustments are made on pricing matters that date back several years, the effective Canadian dollar refund resulting from competent authority settlements should be based upon the foreign exchange rates prevailing at the time of the transactions in question rather than at the time of the payment adjustments when a much larger amount of Canadian dollars would be involved in view of the intervening change in the exchange rates. This will normally result in an exchange loss. Normally, the United States will agree to grant a U.S. taxpayer correlative relief for any exchange loss. The repatriation without additional tax and the correlative relief for the exchange loss should be made part of the competent authority negotiations and the settlement agreed to by the taxpayer.[27]

h. *Taxpayer participation*

Although the taxpayer institutes the mutual agreement procedure by requesting assistance from the country of which he is a resident, the competent authority procedure is a negotiation between the two governments in which the taxpayer does not directly participate. The taxpayer's role is to provide the competent authority with documentation, information, and legal briefs if requested and if necessary to help resolve the case. In addition, it is normal to consult with the taxpayer from time to time to determine what might be an acceptable settlement of the dispute.

Although this procedure has not generally resulted in a significant disadvantage to the taxpayer, occasionally taxpayers have complained that their lack of participation in the consultations has resulted in a decision that is based upon an erroneous understanding of the facts.[28] The 1977 OECD Model Draft Convention con-

20. 1965-1 C.B. 833, amended 1966-2 C.B. 1211, amplified Rev. Proc. 65-31, 1965-2 C.B. 1024.
21. *Schering v. Commissioner*, 69 T.C. 579 (1978), acq. 1981-2 C.B. 2.
22. IRM §8 (24)71.3(7).
23. Ibid.
24. 69 T.C. 579.
25. IRM §(10)(11).7(3)(d).
26. Where royalty payments are allowed, the U.S. competent authority permits repatriation in the currency in which the licensee sold the goods.
27. See Example 1, Section V.
28. Two such complaints were made by practitioners, in an informal survey by the author.

sidered permitting the taxpayer to be a party to a commission hearing in order to avoid such misunderstandings. The procedure has not been adopted.

i. *Payment of tax*

The tax collection procedure varies with each foreign country. In some countries a government determination is followed by an immediate assessment and a requirement for payment. This will prove quite burdensome where the taxpayer feels aggrieved and requests the intervention of competent authority. In some instances the United States competent authority has been able to intercede on behalf of the taxpayer and postpone the payment of the tax assessed.[29]

j. *Interest*

Another incongruity among countries is the imposition of interest and the rate of interest imposed. In some countries there is no interest imposed until the assessment is made, notwithstanding that the transaction took place many years ago. In such instance, the amount of the interest will be a significant factor in the competent authority proceeding. Frequently, the interest is as large as the proposed deficiency. If the competent authority procedure were to result in the United States reallocating income to a foreign country and thereby refunding tax to the taxpayer plus accrued interest while the foreign jurisdiction did not impose an interest charge for the late payment of the tax, the taxpayer will profit, particularly where the foreign tax will ultimately be borne by the United States as a result of the U.S. foreign tax credit. A similar problem, in a lesser degree, arises where the interest rates in the United States and the foreign country are different. The situation is reversed where the U.S. makes the adjustment. In that case, even where both competent authorities agree to equal adjustments the taxpayer may suffer. The U.S. competent authority has no fixed procedure with respect to handling of this situation. It is handled on a country-by-country basis. Both France and Germany refuse to pay interest on refunds. In Canada the interest paid is as much as 16% and is not deductible, although interest received on an overpayment of tax is taxable. The payment or waiver of interest under a mutual procedure settlement is presently being discussed by the OECD. The competent authorities in most countries are not permitted to waive interest when the treaty partner does not pay interest on an overassessment. The U.S., in negotiating its new treaties, desires agreement on the payment or receipt of interest in a competent authority proceeding. Many settlements have been structured to accommodate the interest problem.

k. *Fear of foreign tax authorities*

One practical barrier to the implementation of the mutual agreement procedure in a specific case is the fear that the foreign tax authority will either raise a new issue in the course of the procedure, re-examine a closed year, or more intensively audit the year under consideration. Section 3.03 of Rev. Proc. 82-29[30] states that it is the position of the United States competent authority not to reopen a case previously closed after examination to make an adjustment unfavorable to the taxpayer unless the exceptional circumstances described in Rev. Proc. 74-5[31] are present. If the taxpayer's return was not examined, the District is directed to use regular criteria in reviewing the return for determining the raised issues.[32] In the example of a competent authority procedure case involving Canada described in Section V, the competent authority discovered issues that should have been raised on audit but did not raise them in the course of the competent authority proceeding. Unfortunately, the same is not true for all U.S. treaty partners. Canada, France, Germany and Belgium will not guarantee that they will not conduct full-scale audits not limited to the issue raised in the competent authority proceeding. More importantly, there is a concern among taxpayers that both France and Germany have and will continue to conduct more aggressive, perhaps retaliatory, audits. As stated by one of the respondents to the author's informal survey (not France or Germany), "his government does not look kindly upon taxpayers who raise the mutual agreement procedure". A taxpayer's fear of a detriment to either a current or a subsequent audit is known to the U.S. competent authority. See Question 11(d) of the "Competent Authority Study Group Questionnaire", requesting taxpayers to indicate reasons that they would not recommend seeking competent authority consideration.[33]

l. *Power of competent authority*

Another procedural matter that interferes with the smooth operation of the competent authority procedure is the competent authority designated under the treaty. In the United States the competent authority is a part of the Internal Revenue Service, i.e. the operations function division. In other countries, frequently the competent authority is not part of the tax authority but is in another branch with no direct control over the tax administrators. Without direct line control, the competent authority may be reluctant to reach a result which it cannot enforce. This is stated to be a problem in the mutual agreement process with Germany. Similarly in Italy none of the statutory grounds for refund encompasses a settlement under a mutual agreement.

m. *Multi-country adjustments*

A multi-country issue can arise when the same adjustment relates to more than one country, e.g. an increase in a royalty rate or a sales price. Since all treaties are bilateral, the cases are settled on an individual country-by-country negotiation.

Although it would be worthwhile, the U.S. has not been able to get other countries to meet in a single competent authority proceeding to settle all the issues among themselves. The U.S. does attempt to use a

29. See Example 2, Section V.
30. See Section III, supra.
31. 1974-1 C.B 416.
32. IRM 42(10)(11).5b, 4b.
33. See Exhibit D.

settlement with some countries, where a number of cases are involved, as a standard for negotiations with the other countries, with mixed results.

C. Interpretative provisions

Paragraph 3 of Article 25 authorizes the competent authorities to resolve any difficulties or doubts arising as to the interpretation or application of the convention. It does not mention an aggrieved taxpayer. It assumes that a provision of the treaty is applicable to the situation. It provides for consultation by the competent authorities sua sponte. Although it is unlikely that the situations arose in the absence of a specific taxpayer, the situation contemplated by paragraph 3 will generally be of such importance or wide-spread application[34] that the results will be (or should be) published. An example, which was not published, is the U.S. agreement with the United Kingdom on the taxation of insurance syndicates as having U.S. permanent establishments. The agreement first appeared in the Senate Foreign Relations Report.[35] The situation may arise also when a problem common to a number of treaties is decided, e.g. Rev. Rul. 72-437[36] on disregarding the statute of limitations. A list of U.S. interpretative agreements appears in Exhibit C. The OECD commentaries caution that although this paragraph is intended to give concurrent jurisdiction with the courts or other authorities, that interpretation is sometimes the exclusive right of such other authorities.[37]

Are there any limits on the power of the competent authorities to interpret or apply the convention? The OECD commentary states that the power includes an ability to resolve difficulties not only of a practical nature, but also those which could impede or impair the normal operations of the clauses of the convention as they were conceived by the negotiators, the solution of which does not depend on a prior agreement as to the interpretation of the convention.[38] This language appears to allow the competent authority to interpret a clause in such a manner as to give effect to the general purpose of the convention. However, the example used describes a term that has been ambiguously or incompletely defined in the convention.[39] Where the term has not been defined at all, it is arguable that the competent authority does not have the power to define a term in variance with its state's internal law.[40] This might be particularly true in a country such as Canada that has adopted a statute on the interpretation of a treaty. From time to time, the Internal Revenue Service and the Treasury have held conflicting views on the interpretation and application of the procedure on interpretation and application; the latter have the broader view of its function.

Assuming that the competent authorities agree on a common interpretation, what is the effect? Will it bind a court? Can the Commissioner take a different position in litigation? If the interpretation was a unilateral decision by the Internal Revenue Service, it should have no greater standing than a revenue ruling. It would not have the effect of a legislative regulation as its publication woud not have satisfied the procedural requirements of the Administrative Procedure Act. Does the mutual agreement by both competent authorities add to the force of the interpretation? It is unlikely. Congress has generally preserved its power to adopt legislation and the interpretation has not been passed upon by it. Perhaps ratification of later treaties with similar language might be construed as Congressional adoption, although this rule of adoption by reenactment appears to be waning. The OECD commentary recognizes that the right to interpret treaties is sometimes the exclusive right of other authorities, e.g. the courts.[41]

A similar question is whether an interpretation once adopted can be modified. The OECD commentary states that a mutual agreement is binding on administrations as long as the competent authorities do not agree to modify or rescind the mutual agreement.[42] The position stated in the commentary should be the rule, although there is no authority discussing it. The agreement appears to be more than a ruling, which the IRS need not follow, and more in the nature of a contract between the competent authorities which should bind each competent authority until mutually terminated, i.e. the taxpayer should be viewed as an intended third-party beneficiary.

D. Legislative provisions

The final sentence of paragraph 3 provides that the competent authorities may "consult together for the elimination of double taxation in cases not provided for in the Convention". Unlike the specific case and the interpretative provisions, this provision deals with a situation not covered by the negotiations. It also appears to mean more than just consultation. Paragraph 4 authorizes the competent authorities to communicate with each other directly without following usual diplomatic channels (i.e. through the State Department). Unless paragraph 3 were redundant, the purpose must be broader than mere consultation; it must include reaching a mutual agreement. Both the 1963 and 1977 OECD commentary expressly state that an agreement is contemplated.[43]

The provision, appears to authorize the competent authorities to write a new treaty provision to cover situations not provided for in the convention.

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34. 1977 OECD Model, Art. 25, Comm. Para. 29.
35. Report of Senate Foreign Relations Committee, Senate Executive Report No. 95-18, 95th Cong., 2d Sess. 15-17 (1978).
36. 1972-2 C.B. 660.
37. 1977 OECD Model, Art. 25, Comm. Para. 32.
38. 1977 OECD Model, Art. 25, Comm. Para. 30.
39. Ibid., Para. 31.
40. Art. 3(2), 1981 U.S. Model Treaty and the 1977 OECD Model Treaty.
41. 1977 OECD Model, Comm. Para. 32.
42. 1977 OECD Model, Art. 25, Para. 33.
43. 1977 OECD Model, Art. 25, Comm. Para. 34 and 1963 OECD General Remarks Para. 30. See also 1966 OECD Estate Tax Treaty Art. 2, Comm. Para. 6.

In commenting on this provision, paragraph 34, Art. 25 of the 1977 OECD commentaries states:

> An exception must, however, be made for the case of Contracting States whose domestic law prevents the convention from being complemented on points which are not explicitly or at least implicitly dealt with; in such a case, the convention could be complemented only by a protocol subject, like the convention itself, to ratification or approval.

Until recently the Senate refused to delegate such legislative power to the Treasury. For example, the 1964 Philippine treaty, which was not ratified, specifically limited the competent authorities to consult "for the purpose of *considering the amendment* of the Convention to add provisions dealing with matters not covered in the Convention".[44] A more common example is the power to extend a treaty to overseas territories. The Senate has generally preserved its constitutional authority to advise and consent on all extensions. The procedure for extension would then follow the normal treaty path of a Presidential message of transmittal to the Senate, hearings before the Senate Foreign Relations Committee, a report of the Foreign Relations Committee and a vote by the Senate.[45]

In the 1967 French treaty, the restriction was made explicit.

> The extension of this convention to the Overseas Territories of the French Republic, referred to in Article 29 . . . shall become effective for the United States only in accordance with the procedure set forth in Art. II, Section 2, of the Constitution of the United States ['(The President) shall have Power, by and with the Advice and Consent of the Senate, to make Treaties, provided two-thirds of the Senators present concur'] . . .

More relevant is the reservation with respect to Art. 30, Paragraph 3 of the French treaty (not the provision on Mutual Agreement that is found in Article 25). Article 30, paragraph 3 provided:

> Where, by reason of any change made in the taxation laws of one of the Contracting States, it seems advisable to adjust some provisions of this Convention without affecting its general principles, the necessary adjustments may be agreed between the Contracting States by notes to be exchanged through diplomatic channels or in any other manner in accordance with their respective constitutional procedure.

Notwithstanding the circumspect language employed, the U.S. Senate resolution of advice and consent to ratification contained the reservation that

> the adjustments in the provision of this convention, referred to in Article 30(3), shall become effective . . . only in accordance with the procedure set forth in . . . this Constitution . . .

The Executive Branch appears to have ignored the Senate preservation of its powers in the U.S. Model Treaty in 1977 and 1981 and the provision appears in a number of treaties.[46]

It was not until 1981 in the Report of the Senate Foreign Relations Committee on the Tax Convention with the Republic of Malta that the topic was discussed. Earlier reports had ignored the provision and treated it as conforming with earlier treaties passed by the Senate.[47] The Report on Malta states:

> The treaty also contains a provision that authorizes the competent authorities to consult together for the elimination of double taxation. This provision is intended to permit the competent authorities to perfect and carry out the general purposes of the treaty in particular cases in a manner that is consistent with the expressed general purposes of the treaty. It permits the competent authorities to deal with cases that are within the spirit and sense of the provisions, but which are not specifically covered. Thus, the authority delegated should be construed as analogous to a grant of broad regulatory authority to deal with problems that may arise as distinguished from a grant of legislative authority. It might, for example, be compared to the regulatory authority granted to the Secretary of the Treasury under section 385 or section 482. The provision is not intended to authorize the competent authorities to deal with problems of major policy significance that normally would be the subject of negotiations if they had been focused on during that process.
>
> For example, this provision would not authorize the competent authorities to agree to allow a U.S. foreign tax credit for a tax imposed by the other country where that tax is not otherwise a covered tax or an identical or substantially similar tax imposed after the date of signature of the treaty. Sen. Exec. Rep. No. 97-30, 97th Cong., 1st Sess. at p. 26.

The full implication of the legislative provision and the limitations imposed by the Constitution have not been explored or challenged.

E. Statistics

Statistics on the international usage of the mutual agreement procedure are difficult to obtain. Most countries do not publish them and at least a few appear to be unwilling to disclose them. This may indicate, along with the failure to publicize the procedural steps for invoking the process, an attitude, if not of active discouragement, of lack of enthusiasm for the mutual agreement procedure. Nevertheless, most countries have been parties to mutual agreement procedures at one time or another.

The statistics in the United States are available on request from the Tax Treaty and Technical Services Division, Foreign Operations District. Canadian statistics were recently published by the Canadian Tax Foundation.[48]

The U.S. competent authority has received 951 requests of which it has disposed of 801. Most of its matters have been allocation cases, generally resulting from U.S. allocations. Significantly, the number of

44. Art. 19(2).
45. E.g. vote on U.K. Extension, 100 Cong. Rec. at p. 15367.
46. Hungary, Art. 22(3); Poland, Art. 22(3).
47. Hungary, Treas. Dep't Tech. Explanation, Sen. Exec. Rep. No. 96-8, 96th Cong., 1st Sess., Poland, Treas. Dep't Tech. Exp., 1977-1 C.B. 427.
48. Both sets of statistical information are attached as Exhibits A and B.

cases arising from foreign allocations has risen since 1980 and in the last few years has exceeded the U.S. allocation cases. More than 90% of these cases involved U.S. parent corporations. The success ratio is high. Seventy percent of completed cases resulted in full taxpayer relief; 9% resulted in partial relief. The percentage in which the taxpayer was a stakeholder, as a result of the U.S. foreign tax credit, is not disclosed;[49] nor is the source of the relief, i.e. U.S. or treaty partners. The percentages are higher if negotiated cases only are considered, i.e. 81% full relief and 11% partial relief.

More than 50% of the mutual agreement requests involve Canada. The competent authority has informally stated that about 30% involve Germany, France and the United Kingdom and the remaining 20% were mainly with Belgium, Australia, the Netherlands, Sweden, Switzerland, Norway, Italy, Korea and Japan.

The increase in the number of cases has been accompanied by an increase in the average duration[50] to dispose of a case. In 1985 the average duration was slightly less than 24 months. This includes months that a case may be held in suspense as a result of a case being subject to review by the Joint Committee on Taxation.

The Canadian Competent Authority Operations Section Workload Analysis for the year ended 31 March 1984 shows that 84% of their cases are with the United States and most of the cases are Canadian initiated. The volume of competent authority cases has increased over the last decade but appears to have plateaued at an inventory of approximately 75 cases.[51]

III. U.S. COMPETENT AUTHORITY – PROCEDURAL ASPECTS

A. Competent authority – Operations and staff

Under most United States income tax treaties, the authority to act as U.S. competent authority is assigned to the Secretary of the Treasury. Under the present income tax treaties with Austria, Denmark, Greece, Ireland, Italy, the Netherlands and South Africa the authority to act as U.S. competent authority is assigned directly to the Commissioner. In either event, the authority has been redelegated to the Associate Commissioner (Operations) who has been given the authority to negotiate competent authority agreements to resolve (a) double taxation and (b) other tax issues in order to provide relief to taxpayers. The Associate Commissioner (Operations) has complete authority with respect to double taxation. He is required to obtain the agreement of the Assistant Commissioner (Technical) when the issues relate to an interpretation or application of the treaty. The Associate Commissioner (Operations) is aided by the Tax Treaty and Technical Services Division of the Foreign Operations District (FOD). Although the FOD is under the jurisdiction of the Mid/Atlantic Region, it is located in Washington. The Division is divided into three groups. Two groups within the Tax Treaty and Technical Services Division of the Foreign Operations District process allocation and treaty interpretation issues. Both groups are headed by case managers. The third group provides technical assistance to the Associate Commissioner. The Division attempts to keep itself staffed with Grade 13 level employees, all of whom have prior audit experience. Most of the Division employees have had extensive field experience as international examiners before transferring to the FOD. With the forthcoming change to the creation of an Associate Commissioner (International) it is likely that the authority to act as competent authority will be delegated to him. The competent authority is aided in foreign countries by the local Internal Revenue Service representatives (except Ottawa) who will present position papers to the foreign authorities and conduct negotiations on behalf of the taxpayer and the U.S. Government. Complex negotiations, of course, are reserved for higher level personnel.

Within each group in the Tax Treaty and Technical Services Division, each analyst tends to specialize on an issue-by-issue basis or on a country-by-country basis. Although the decisions are not precedential, familiarity with the issue and familiarity with the way that the matter has been settled with the opposite competent authority or with other competent authorities is extremely relevant. Their familiarity with the issue assists the analysts in analyzing the reports prepared by the Appeals Office and may result in a withdrawal of the assessment or the returning of the file to the taxpayer's district for a more complete analysis. In all cases the analyst will meet with the International Examiner and with the taxpayer or his representatives to flesh out the case, develop the facts, develop the issues and assist the U.S. competent authority in presenting the case to the foreign competent authority. In most cases the U.S. taxpayer and his advisors are very much involved. However, neither the taxpayer nor his advisor may be a party to the actual negotiations between the two competent authorities. Frequently, the U.S. competent authority will meet with the taxpayer and his advisors immediately prior to a session with a foreign competent authority and then subsequent thereto discuss the meeting with them. It is not uncommon for U.S. taxpayers and their advisors to fly overseas to be readily available to the U.S. competent authority in the course of the negotiations.

There is no consistent pattern of meeting with the

49. Reg. §1.905-2(e)(5) provides that a foreign tax will not be creditable unless the taxpayer exhausts all "effective and practical remedies, including invocation of competent authority procedures available under applicable tax treaties" to reduce the taxpayer's foreign tax liability. See also Rev. Rul. 76-508, 1976-2 C.B. 225 and Rev. Rul. 80-231, 1980-2 C.B. 219.

50. The average duration of a closed case is from the date a case is received until the date a case is closed.

51. Calderwood, John A., "A Revenue Canada Perspective on the Role and Method of Operation of the Competent Authority" 36th *Canadian Tax Foundation*, 315 (1984).

foreign counterparts; whenever there are sufficient cases, the competent authority tries to start negotiations. An exception is Canada. Here, because of the frequency of the competent authority cases, the United States and Canada have agreed to meet quarterly, alternating between Washington and Ottawa.

B. Filing the request for competent authority assistance

1. Contents and place

Revenue Procedure 82-29[52] establishes the procedure for requesting U.S. competent authority assistance in allocation cases. Rev. Proc. 77-16[53] establishes the procedure for all other cases, including interpretation, e.g., source of income, residence, withholding, characterization of income, permanent establishment, and allowance of deductions.[54] The procedures provide that they do not override any applicable treaty provisions, but it is difficult to determine what treaty provisions the authors were considering. The Canadian authorities have established their own procedure.[55] No other country seems to have a written procedure for requesting competent authority. Perhaps this is one reason for the small number of competent authority requests in other countries.

A request for competent authority assistance requires extensive documentation. In general, the taxpayer must submit a detailed analysis of the factual situation, the proposed adjustment and the position of each of the two governments. The taxpayer is also obligated to provide English language translations of all relevant foreign tax returns and correspondence. Further, the taxpayer is under a continuing obligation to "supply any additional information needed to resolve the case and keep the competent authority informed about proceedings in the treaty country or any other pertinent developments". Failure to supply the required documentation or any "additional information" are grounds for denial of assistance.

In U.S. initiated cases, the request is filed with the Service office where the case is pending, with a copy to the U.S. competent authority. If the case is pending in court, the request is filed with the Chief Counsel, with a copy to the U.S. competent authority. In foreign initiated allocation cases, the request is filed directly with the U.S. competent authority. The taxpayer is required to consent to disclosure to the foreign competent authority of any of the items set forth in the request. The U.S. competent authority reserves its right under the applicable treaty to disclose such information even in the absence of consent.

2. Time to file request

Under the Revenue Procedure and most treaties, a taxpayer may file a request for competent authority assistance as soon as it has received adequate information about the proposed adjustments and believes that the adjustment may result in double taxation. It need not first exhaust its domestic remedies nor need it wait until it can prove actual double taxation. Notwithstanding this rule, in a recent request for competent authority, we had to submit an opinion that the U.S. would not grant unilateral relief in order for the foreign competent authority to accept the request. If the taxpayer wishes to delay filing the request, it should consider any applicable treaty or domestic procedural limitation. A few U.S. treaties impose a limit on the time for requesting competent authority. Further, the domestic law of the treaty partner may impose procedural limitations which, unless waived by the treaty, may bar a request for competent authority assistance. Some treaties have specific periods limiting initiation of the mutual agreement procedure, e.g. Canada – 6 years from the year under audit. Older treaties may have procedural bars, but the competent authorities have circumvented the limitation in some cases by making adjustments in later years, i.e. those not yet barred by the statute of limitations. The U.S. period is from the receipt of computation schedules from the International Examiner to the filing of a petition to the Tax Court. A competent authority request may also be filed during court proceedings, subject to the consent of the Chief Counsel who will consult with the Department of Justice in appropriate cases who will usually suspend the proceedings. The more recent treaties specifically allow the competent authority to grant relief notwithstanding procedural bars, such as the statute of limitations or closing agreements, and the U.S. has interpreted older treaties in a similar manner.[56] After a court decision, the competent authority may accept a case, but only to persuade the treaty partner to grant a correlative adjustment.[57]

a. *U.S. adjustments*

Rev. Proc. 82-29 provides that a request "should be submitted as soon as the amount of the adjustment is determined, communicated in writing to the taxpayer, and agreed to by the taxpayer . . . ." However, this language is not binding. Thus, the taxpayer may accelerate the request for competent authority assistance to the time of receipt of a substantially completed International Examiner's Report, although it does not agree with the proposed adjustments. Alternatively, the request for assistance may be deferred until after an administrative review by the Appeals Office.

The immediate filing of a request for competent authority relief may put a taxpayer at a distinct tactical disadvantage, since it must indicate at least tentative agreement with the proposed adjustment, subject to the obtaining of a correlative adjustment from the

52. 1982-1 C.B. 481.
53. 1977-1 C.B. 573.
54. No procedure has been published for estate tax cases, although competent authority negotiations have taken place.
55. Circular No., 71-17R2 (9 July 1984).
56. Rev. Rul. 72-437, 1972-2 C.B. 660. This is the U.S. view. It is not clear that the treaty partners agree. It is reported that Japan agrees, the U.K. disagrees, and Germany accepts it only in part. Cole, Huston & Weiss, "Mutual Agreement - Procedure and Practice," Vol. LXVIa, Cahiers de Droit Fiscal International, International Fiscal Association, 1981 at p. 266.
57. IRM 42(10)(11).5(d)1.

foreign country. Further, Rev. Proc. 82-29 requires that the taxpayer indicate its willingness to accept a competent authority agreement that is not clearly unreasonable or unfairly prejudicial to the interests of the United States as a condition to competent authority assistance.

b. *Foreign adjustments*

Rev. Proc. 82-29 provides that taxpayers should file the competent authority request "as soon as practical after the treaty country's position on the adjustment has been sufficiently developed to permit consideration, whether or not the adjustment has been formally proposed," and in any event "no later than 90 days after the treaty country's adjustments are formally communicated to the related party." However, this language is only precatory and not binding on the taxpayer. In order to preserve the taxpayer's rights, he should immediately file an amended tax return claiming a deduction or additional foreign tax credit. The taxpayer should also pursue his foreign rights, possibly requiring an appeal, in order to prevent the foreign statute of limitations from expiring and to preserve the right to a foreign tax credit.

While invocation of the mutual agreement procedure is not mandatory, in certain instances failure to utilize it may result in the loss of foreign tax credits.[58] The taxpayer need not accept the result of a mutual agreement procedure and may withdraw its request at any time. While the Service may deny such withdrawal in the interest of U.S. revenues, it usually permits withdrawal.

3. Proper parties

The competent authority will consider requests for invocation of the mutual agreement procedure only from U.S. residents or citizens. Requests received from non-resident alien individuals and foreign corporations, partnerships or other entities will be referred to the competent authority of the country of residence (as defined under the applicable treaty) of such individual or entity. Since a U.S. subsidiary of a foreign corporation is a U.S. resident, this should cause hardship only in situations involving a foreign corporation with a U.S. branch. In such cases, if the foreign country does not respond to a request for competent authority, the U.S. may consider a request from the foreign corporation. If a mutual agreement procedure is invoked through the competent authority treaty partner, then the U.S. will notify the U.S. taxpayer and request that it follow the normal procedures for requesting invocation of a mutual agreement procedure.

In *Filler v. Commissioner*, 74 T.C. 406 (1980), a U.S. citizen attempted to request a mutual agreement procedure through judicial intervention. The court held that the procedure is entirely administrative, not judicial. The court could not compel the procedure. The taxpayer was taxed by both the U.S. and France on that portion of his compensation income earned in the U.S. Under the treaty the court stated that France had agreed to provide a credit for U.S. income taxes on income from sources within the United States. The taxpayer has unsuccessfully sought relief from the French authorities. The mutual agreement procedure article in the French treaty required presentment to the country in which the taxpayer was a resident. The court expressed no opinion on whether the U.S. citizen could invoke competent authority proceedings by presenting his case to the competent authority of the U.S., notwithstanding the language of Article 25 of the French treaty.

The ABA Committee on U.S. Activities of Foreign Taxpayers has proposed that taxpayers should be given the option of presenting their cases to the competent authority of either state as suggested by Paragraph 15 of the OECD Commentary on Article 25 and presently exists in the U.S.-Pakistan income tax treaty (Art. XVI), the estate/gift tax treaties with France (Art. 14), the Netherlands (Art. 13) and the United Kingdom (Art. 11). Revenue Procedure 77-16 now permits access to the U.S. competent authority only where a foreign government refuses to allow a foreign tax credit authorized by the treaty and only after the taxpayer has exhausted all his legal remedies, presumably including pursuing the matter in court. The ABA also suggests that Rev. Proc. 77-16 (dealing with non-allocation cases) be expanded to allow a taxpayer to seek competent authority relief where the action is by the U.S. in addition to action by a treaty partner and expanded to cover actions against a person related to the U.S. taxpayer, in addition to the U.S. taxpayer. Examples are a mismatch in the characterization of a transaction (e.g. interest recharacterized as a dividend for foreign purposes but as interest for U.S. purposes with the absence of a foreign tax credit) and discrimination against a foreign subsidiary of a U.S. corporation.

4. Choice of the appeals procedure or mutual agreement procedure

If the IRS International Examiner proposes an allocation with which the U.S. taxpayer disagrees, the taxpayer has the option of filing a competent authority request immediately, or submitting its case to Appeals. If a potential double taxation will be proposed, the International Examiner must notify the taxpayer of his rights to seek mutual agreement procedure assertions.[59] The letter requests a non-binding statement of the taxpayer's intention concerning the mutual agreement procedure. Since the benefit of the foreign tax credit (the effective foreign rate is increased by allocating income to the U.S.) for the allocated amount is contingent upon requesting a mutual agreement procedure, submission to Appeals does not eliminate the need for requesting a mutual agreement procedure.

Generally, a taxpayer would file immediately a competent authority request, and not first go to Appeals,

58. Treas. Reg. §1.901(e)(5). The reallocation of deductions under Treas. Reg. §1.861-8 that affect the foreign tax credit is normally not a treaty issue.
59. IRM 42(a)(11).5(2)(a).

either because it anticipates more favorable treatment from the competent authority than from Appeals, or to minimize legal expenses. Examples might be de minimis adjustments or situations where the taxpayer is only a stakeholder. In some cases the competent authority, after review, has instructed the District Office to withdraw the adjustments in the absence of greater factual development. Generally, the District Office will comply. If the competent authority agrees that there should be an adjustment, but believes that the proposed adjustment is excessive, it will present a reduced proposed adjustment to the foreign competent authority.

Rev. Proc. 82-29 encourages taxpayers to go to Appeals before filing a competent authority request. However, the competent authority's position is that while taxpayers who consider any allocation adjustment inappropriate should *preferably* first preserve this right of communication with Appeals, taxpayers who dispute only the amount of the adjustment need not go to Appeals first.

In deciding whether to attempt to negotiate a settlement with Appeals before filing a request for competent authority relief, taxpayers should be aware that the IRS Manual[60] contains specific instructions to Appeals officers handling cases which may later be the subject of a competent authority request.

The principal ones are:

a. lump-sum and traded-issue settlements are to be avoided if they involve competent authority issues;
b. no attempt shall be made to secure the taxpayer's agreement not to file a competent authority request, nor shall concessions be made in return for any such agreement or understanding;
c. any closing agreement must preserve the Commissioner's right to adjust the taxpayer's taxable income, foreign tax credits or earnings and profits to reflect any agreement reached by the two competent authorities which is accepted by the taxpayer;
d. no consideration may be given to factors traditionally considered by a competent authority, i.e. rights under the treaty, foreign statute of limitations, prior competent authority agreements involving the taxpayers, pricing guidelines other than those of the Section 482 regulations, etc.; and
e. the case is to be returned to the District level for further development if the facts are not sufficiently developed.

C. Denial of request for competent authority assistance

1. Basis for denial

The mutual agreement procedure is encouraged by the Treasury Department and the IRS. Consequently, where the treaty requirements for the mutual agreement procedure are satisfied and the taxpayer follows the procedural requirements, it is unusual for a request to be denied. A request may be denied for substantive or procedural reasons.

a. *Substantive.*
The competent authority may find (1) that the case is "unsuitable for consideration or assistance," (2) that the taxpayer is not entitled to treaty benefits, or (3) that the case involves tax fraud or tax evasion, either in the U.S. or abroad.

b. *Procedural.*
The procedural grounds for denial are:

(i) taxpayer did not furnish sufficient information. Generally, it will be given a chance to supply additional information as it becomes available;
(ii) the taxpayer is under the jurisdiction of another competent authority;
(iii) the request for competent authority assistance involves a case pending in court and the Chief Counsel's consent has not been granted. Such consent is usually obtainable;
(iv) the taxpayer's refusal to execute a consent extending the period of limitations;
(v) the taxpayer insists on participating in the negotiations between the competent authorities; and
(vi) the taxpayer will only accept a settlement that is "clearly unreasonable or unfairly prejudicial to the interests of the United States."

Any attempt by the U.S. taxpayer (or its foreign affiliates) to assist the foreign competent authority in resisting the U.S. proposed adjustment may be considered grounds for the U.S. competent authority to refuse any further assistance and withdraw its acceptance of the taxpayer's request for competent authority relief.

2. Appeal of denial

The taxpayer has the right to appeal a denial of a request for competent authority assistance.[61] A request for appeal is made to the Commissioner of Internal Revenue who designates a panel to review the denial. The taxpayer may have a conference with the panel. The panel's decision is final, and it is the IRS' position that it is not subject to judicial review. Experience with the appeal procedure has not been satisfactory as the panel members frequently do not have international experience.

D. Unilateral relief

1. De minimis

The competent authority has the power to grant unilateral relief without consulting the treaty partner if he determines that the amounts involved in a case are too small for mutual agreement purposes.[62] The questionnaire[63] requested taxpayer's comments on what amounts should be considered de minimis and used ranges of \$10,000, \$10,000 – \$25,000, \$25,000 – \$50,000, \$50,000 – \$100,000, and divided the ranges

60. IRM 8(24)71.2.
61. §9.03, Rev. Proc. 82-29 and Rev. Procs. 79-31 and 79-32.
62. IRM 42(10)(11).3(3).
63. See Exhibit D.

into categories for interest, royalties, pricing, rent, intangibles, services, and research and development.[64] The author is aware of a withdrawal of a $25,000 royalty adjustment. The manual provides that "In making this determination, the U.S. competent authority applies others factors that may differ from those applied by examiners." It is not clear what the quoted sentence means, but it appears to give the competent authority considerable freedom in granting unilateral relief.

2. Expired statute of limitations

The IRS has withdrawn proposed adjustments when the foreign country is barred from granting a correlative adjustment, and the taxpayer is not at fault. However, such relief is entirely discretionary and certain conditions are imposed:

(i) no relief will be granted in the absence of an applicable treaty;
(ii) a timely request must be filed with the U.S. competent authority;
(iii) the taxpayer must not have had timely notice, whether actual or constructive, of the U.S. adjustment until it was too late to avail itself of remedies in the foreign jurisdiction;
(iv) the proposed adjustments must not involve abusive tax arrangements;
(v) the taxpayer must not have been subject to recurring adjustments;
(vi) there is the absence of fraud or negligence in the relevant transaction.[65]

E. Acceptance of request

1. Stages

The competent authority consists of four stages: development, preparation of position paper or rebuttal paper, negotiation, and closing.

a. *Development*

The first step by the competent authority consists of determining whether the case is a proper matter for mutual agreement procedure and whether it is sufficiently developed for negotiation.

(i) *U.S. adjustment.*
The competent authority may return the case to the District level for further development, modify the adjustment, determine that the issue should first be heard by the Appeals Office or withdraw the adjustment if it considers it unreasonable.

(ii) *Foreign adjustment.*
Upon receipt of a notice of a foreign adjustment, the competent authority evaluates the merits of the adjustment. If it believes that the adjustment lacks merit, it will so advise the foreign competent authority prior to preparing a full-scale position paper. Some foreign countries have withdrawn adjustments upon such advice.

b. *Position/Rebuttal paper*

If the competent authority accepts the case, the next step is the preparation of a position or rebuttal paper. This forms the basis for the presentation of the U.S. position to a foreign competent authority, for subsequent negotiations.

The taxpayer's cooperation is frequently requested to provide additional information. At the same time the taxpayer's related entity in the foreign country may be asked for information by the foreign competent authority. Thus, it is crucial to maintain a central clearing house in charge of supplying information to the two competent authorities, to prevent inconsistencies or misunderstandings.

c. *Negotiations*

The form of the negotiating procedure depends on the countries involved. Negotiations may be oral or entirely in writing. In most countries, the local Revenue Service Representative presents the position paper and initiates negotiations, factors which speed the process. Taxpayers do not directly participate in negotiations. However, the competent authority will consult with them during discussions, and failure to cooperate may result in dismissal.

d. *Closing*

If the competent authorities and the taxpayer all agree on a settlement, the competent authorities will sign a disposition memorandum. The taxpayer may be asked to sign a closing agreement relating to the competent authority procedure, which is binding on both the IRS and taxpayer; the disposition memorandum and any closing agreement will be transmitted to the District Director for implementation. Where an adjustment by one country has been agreed upon, the other country will typically grant a correlative adjustment. Closing agreements can recharacterize dividends as payments for goods, services, or technology or as nontaxable payments.

F. Withdrawal of request

The taxpayer has no obligation to sign a closing agreement or accept the settlement of the competent authorities. It may decide to pursue normal domestic remedies in the U.S. or in the foreign country. However, in an allocation including a foreign adjustment, the taxpayer may be foreclosed from pursuing domestic law remedies in the U.S., i.e. a taxpayer cannot force a correlative adjustment under §482. The information submitted to aid the U.S. competent authority cannot be withdrawn. Any factual knowledge obtained in the course of the mutual agreement procedure may be used against the taxpayer in the Appeals Office or in court.

64. Liebman, "The Practice and Procedure of Competent Authority," 58 Taxes 363 states that the competent authority de minimis is "less than $ 25,000 or 1% of sales if less than $ 100,000" at p. 371.
65. §9.06, Rev. Proc. 82-29, 1982-2 C.B. 481.

G. Effect on domestic proceedings

1. IRS audits

The competent authority has exclusive authority over issues subject to a request for competent authority assistance. If a request for competent authority assistance is granted with respect to an item under audit, administrative proceedings on the issues accepted for competent authority proceedings will be suspended.[66] If some of the issues being examined are not competent authority issues, then administrative proceedings will continue, but Appeals will not issue a deficiency notice until resolution of the competent authority issue. If some or all of the other issues are agreed at the audit level, the agreed issues can be effectively closed out by executing a partial Form 870 consenting to assessment of the tax relating to the agreed issues. Any closing agreement reached with the IRS will exclude the competent authority issues. This procedure keeps the case in the field or on the Appeals Office case docket, adding to the number of unagreed or suspended cases; this is one reason why the District and the Appeals Offices are unhappy with competent authority requests.[67]

If a request for competent authority relief is filed before Appeals Office consideration of any other unagreed issues is requested, the protest need not include the competent authority issues.[68] However, the taxpayer should include a statement in its protest to the effect that the request for competent authority relief has been filed and that the taxpayer reserves the right to protest the competent authority issues at a later date.

The mutual agreement procedure may be invoked with respect to a closed case, without triggering a new audit. (This contrasts with the practice in other countries.) However, the filing of a request for foreign competent authority assistance by a foreign party related to a U.S. taxpayer may result in an audit of the U.S. taxpayer. Normally the District is told to review only the competent authority issue unless the taxpayer's return would otherwise be audited under normal criteria.[69]

2. Court proceedings

While a taxpayer may request competent authority assistance during court proceedings, it must obtain approval of the Chief Counsel (which is usually, but not always, given) who, in cases not in the Tax Court, must consult with the Department of Justice.[70] The government will request the suspension of proceedings, which will be granted if the court feels that the adjustment has merit. If the competent authority procedure does not result in agreement between the competent authority and the taxpayer, the taxpayer may reinstitute the litigation. If an agreement is reached, a binding closing agreement will be signed and presented to the court as a stipulated settlement.

If an adjustment arises out of a foreign adjustment for tax years with respect to which there is a judicial decision concerning the taxpayer's liability, correlative adjustments will not be made unless the treaty waives domestic time limitations.

H. Joint Committee

Any refund or credit of $200,000 cannot be made prior to a report to the Joint Committee on Taxation. Thus, a closing agreement in a mutual agreement procedure may require prior submission to the Joint Committee. (There are certain exceptions applicable to the withholding tax.) While not required, the IRS will customarily withhold from awarding a refund or credit until it receives a report from the Joint Committee.

I. Confidentiality

A taxpayer making a request for competent authority assistance may be subject to extensive disclosure requirements concerning its operations and, in the case of allocation cases, the operations of its foreign affiliates. This information may well be disclosed to the foreign competent authority, which may not have any internal laws against the disclosure of such information. Thus, the competent authority procedure may be disadvantageous to the extent that it may result in the disclosure to foreign governments, or to the taxpayer's business competitors, of sensitive information.

The IRS may disclose a taxpayer's "returns and return information" to a foreign competent authority only if the applicable treaty authorizes such disclosure.[71] All treaties contain a mutual agreement provision authorizing or directing the competent authorities to exchange such information as is necessary for carrying out the provisions of the convention, e.g. 1981 U.S. Model Treaty, Art. 26(1). Most treaties limit this power by exempting certain business information, e.g., 1981 U.S. Model, Art. 26(2)(c), Canada, Art. XXVII(3)(c). However, the protection afforded varies. Many older treaties prohibit disclosure, while the most recent treaties merely exempt such information from mandatory disclosure. The more recent treaties would seem to allow disclosure at the discretion of the competent authority, and this is the Treasury's position as well as that of the OECD commentary.[72] Cf. *U.S. v. Toyota Motor Corp.*, 561 F. Supp. 354 (C.D. Cal. 1983).

Examples of protected business information are trade, business, industrial, commercial or professional secrets of trade processes. Thus, technology, patents and know-how would appear to be protected. In a 1976 speech a Treasury Official indicated that pricing data will be considered a trade secret if it satisfies three conditions:

66. §5.05, Rev. Proc. 82-29, 1982-2 C.B. 481.
67. IRM §8(24)71.3(6).
68. §5.05, Rev. Proc. 82-29, 1982-2 C.B. 481.
69. IRM 42(10)(11).3(4).
70. §5.06, Rev. Proc. 82-29, 1982-2 C.B. 481.
71. IRC §6103(k)(4).
72. 1977 OECD Model, Comm. Art. 26, Para. 17.

1. The information is, in fact, secret from those not directly involved in the transaction;
2. The information would confer a competitive advantage; and
3. The pricing arrangement is not part of a plan to evade or avoid taxes or distort the tax consequences of a particular transaction.[73]

Although most treaties protect business information, because such information may very often be the heart of the case, Rev. Proc. 82-29 requires that taxpayers who file a competent authority request with respect to an allocation case must consent to the disclosure by the U.S. competent authority to the foreign competent authority of any information contained in the request for competent authority assistance.[74]

The disposition memorandum signed at the conclusion of the mutual agreement procedure, as well as any closing agreement, is not made available to other taxpayers, even with the deletion of identifying information.[75]

IV. COUNTRY SURVEY

Mutual agreement proceedings are not as successful with all U.S. treaty partners. Discussions and communications with taxpayers and tax advisors who have been involved in competent authority proceedings indicate that the degree of success in a competent authority proceeding depends upon the nature of the dispute and the other country participant. One cause of the variance is probably the smaller number and lesser amount involved in the cases where the taxpayer is a resident of a foreign country. The treasury or similar department of a sovereign state does not usually like to surrender tax revenues to another country. Yet, that is what is requested in a competent authority proceedings. The United States has been in the forefront of the drive on transfer pricing. Until recently it was the U.S. that was always requesting its treaty partners to surrender tax revenues. While the OECD countries have been increasing their audits of transfer pricing the number and value is still weighted heavily to the U.S. Of similar importance is the nationality of the parent company. In the end it is the parent company and its shareholders who bear the cost of taxation not in accordance with the convention. The majority of the world's multinational parent corporations is still incorporated in the U.S. Until the U.S. is able to negotiate something in return, satisfactory proceedings may be difficult to achieve.

While based on a limited sample, the following represents the views of a small number of taxpayers and tax advisors on the probable success of a competent authority proceeding with some U.S. treaty partners, ranked in descending order of the probability of a favorable outcome:

Best

Canada. U.S. most successful partner. Previously had statute of limitations problem. The new treaty should eliminate it. Still have currency and interest questions. Some instances of field auditors increasing deficiency on notice of competent authority procedure. May desire U.S. taxpayer to exhaust its U.S. remedies.

United Kingdom, Norway and Sweden. Number of successful mutual agreement procedures concluded. Practitioners are uniformly happy.

Average

Australia. A large number of cases under prior treaty involved royalties. They were settled fairly well. They have a tendency to raise other issues. Have not waived statute of limitations, but have allowed current adjustment.

Belgium. Allocation cases require juridical double taxation. On other issues, such as royalty and management fees, the procedure has worked well. Extremely time-consuming; procedure will not start for at least a year.

Denmark. Not generally interested. They consider it a bother.

Korea. Procedure appears to be working well, although there appears to be a tendency to find offsets.

Netherlands. Mutual agreement procedure works well. Time-consuming process.

Switzerland. Will not waive statute of limitations. See *Schering* case on repatriation which is Swiss normal rule.

Worse

Italy. Requires juridical double taxation under 1956 treaty. Has a tendency to raise new issues. General view from U.S. and other countries that successful settlements are difficult. There is no provision under domestic law permitting a refund, and the tax official concerned may be personally liable for an erroneous refund.

Germany. Extremely difficult on allocation cases. Negotiations are protracted. Has a tendency to raise new issues. Ministry has to obtain local government approval. Better on application issues. Will not pay refunds with interest. Adopts same position with other treaty partners.

Japan. Practitioners advise that competent authority has stated that they will not give refunds. History of no settlements, but possible recent change.

France. Apparently France believes consultation is sufficient. Allocation cases are rarely, if ever, settled. Other issues are better. Has a tendency to retaliate. Will not pay interest on refunds.

73. Hufbauer, Gary, "Model Income Tax Treaties and Exchange of Information Provisions" for Delivery at Convention of Inter-American Center of Tax Administrators, San Salvador (1976).
74. §§4.04(1) and 5.07(1).
75. See fn. 11.

V. TYPICAL CASES – RECENT EXAMPLES

A. Example 1 – Canada – Denial of management fees and interest

The years involved were 1977 through 1979. The case was presented to the competent authority in October 1981. The taxpayers involved were a Canadian subsidiary and a U.S. parent. There were two adjustments involved:

(1) The Canadians disallowed a portion of management fees, some in part, some in whole, depending upon the nature of the fee, and treated the amount disallowed as a dividend. After the Canadian taxpayer filed a protest with the Canadian authorities, the Canadian Revenue authorities went back to the case and disallowed 100% of the management fees, treating them all as dividends. They also imposed a withholding tax on the amounts that were disallowed but had been paid. The U.S. parent maintained a cost center for its numerous management functions, the costs of which it charged to all its subsidiaries. These functions included advertising, computer services, accounting fees, economic analysis, etc. There were 15 or more separate services in the management fee. The initial disallowance for the management fee was in excess of $7.5 million plus treatment of the payment as dividends subject to withholding. The disallowance was raised to an amount over $10 million and the withholding was in excess of $1 million.

(2) The second adjustment involved a disallowance of the interest paid by the Canadian subsidiary to the U.S. parent. With respect to the interest issue, the parent company had made a substantial loan to the Canadian subsidiary, fully documented. The term of the loan was 15 years. The loan bore a fixed rate of interest and provided for adjustment after 5 years. The Canadians disallowed the change in the interest rate after the first 5 years and allowed only the original rate of interest. The term of the loan was also extended at the time of the increase in interest.

It took almost 18 months for the Canadian competent authority to respond to the U.S. submission requesting the justification for the adjustments. The initial Canadian response related only to the disallowance of the management fees. The Canadian position was that they would allow a cost reimbursement only and not allow a profit on the cost, similar to the U.S. position under Treas. Reg. §1.482-2(b)(3). (In this particular case, however, the parent corporation was performing similar computer services for outside parties and was operating the computer service as a profit producing activity.) Pending the response of the Canadians, the United States forwarded the case to the District Director's office to evaluate the Canadian position. The District Director's office reviewed the U.S. parent's operations, tax returns and justifications. In the course of the review, they found charges that it felt that the U.S. parent should have been charging its Canadian subsidiary, which it had not. Using that information plus the fact that the taxpayer had sold some of its services to unrelated parties, the competent authority prepared its position paper with the aid of the taxpayer for a presentation to the Canadian competent authority. In May 1983 the Canadians finally submitted their position paper with respect to the evaluation of the issues. The United States presented to the Canadian competent authority its rationale on the justification for the management fee and the reason third parties would enter into a long-term loan agreement under which the interest would fluctuate from time to time. The United States took the position that with respect to the interest the Canadians had no basis for disallowing any portion of it. The final U.S. position on both issues was submitted in September 1983. Normally the United States meets four times a year with the Canadian competent authority (two times in Ottawa and two times in Washington). Generally there are 12 to 15 cases that are discussed at each quarter-annual meeting. However, for this case the competent authorities had a special meeting. The Canadians requested that the meeting take place in Toronto which was the District Office of Revenue Canada that instituted the adjustment. Normally the United States would object to attendance at a meeting with the district auditors since they feel that the district has an interest in defending an assessment it has made. However, the United States agreed and the meeting took place in Toronto and lasted for a period of four days. During the first two days the district people were present and during the last two days they were excused. The four-day meeting resulted in agreement in concept with the two competent authority analysts agreeing to exchange calculations during the next few weeks. The taxpayer was totally involved in the discussions from the beginning through the consultation process in Toronto, although by law the taxpayer cannot participate in the conference. From December 1983 to December 1984 the analysts, working within the framework of the conceptual agreement, worked out the details of the compromise. The taxpayer was consulted frequently, particularly with respect to the production of new information. The Canadian analyst did not agree with the entire conceptual agreement, particularly with respect to the method of repatriation and the currency that was involved. The analyst wanted the repatriation in U.S. currency. In January 1985 the Canadian competent authority submitted a settlement letter with its computations. The United States objected to the proposal. The matter was negotiated during the summer of 1985 with three meetings taking place, the last one in July. A final meeting occurred in November 1985 at which time the Canadians agreed to repatriation of funds in Canadian dollars, but insisted on using the exchange rate in the year of the transaction but eliminating the currency gain from tax. The deficiency with respect to the management fee was reduced to $3.5 million and repatriation was permitted without the imposition of a withholding tax, except for a withholding tax on the small portion of the agreed-upon profit that the U.S. parent should have been charging to the U.S. subsidiary on services it also provided for third parties.

With respect to the interest issue, the U.S. worked out a settlement where the original amount of the loan bore interest at the original fixed interest rate and subsequent additions to the original loan bore interest at a higher rate. The total deficiency on the interest was reduced from $3.3 million to $950,000. As noted above, one of the issues involved was the currency rate of exchange. The taxpayer and the Internal Revenue Service gave in to the Canadians because of the favorable settlement reached by all parties, realizing that all settlements result in some losses of position.

A number of points are demonstrated by this case. First, it shows that the Internal Revenue Service will thoroughly investigate the foreign competent authority's position and with the aid of the taxpayer will prepare an appropriate case for eliminating or reducing the foreign deficiency. Second, it demonstrates that the Internal Revenue Service will not raise affirmative issues with respect to a taxpayer even though they were discovered in the course of preparing for the competent authority proceeding, but they will use them in arguing the taxpayer's position before the competent authority. (In this case the U.S. felt that the Canadians should have been bearing additional management fees that the taxpayer had not charged to them.) Finally it demonstrates that the Canadians do not look for an offset in order to retain the original deficiency, although they had increased the deficiency for bargaining purposes.

B. Example 2 – Permanent establishment and agent's commissions

This situation involved a U.S. parent and foreign subsidiary. The foreign country (the taxpayer requested that the country not be disclosed) determined on audit that the U.S. parent had a permanent establishment in the foreign jurisdiction, notwithstanding a treaty provision that the determination of whether a resident of one country has a permanent establishment in the other country is to be made without regard to the fact that the resident may be related to a resident of the other country or to a person who engages in business in that other country.[76] The years involved were originally 1980 and 1981 and were later extended through 1985.

The foreign country made the determination in 1983. The taxpayer filed a protest arguing that the local subsidiary did not have the power to conclude contracts and therefore did not constitute a permanent establishment. All contracts with respect to any sale or lease were reviewed, negotiated and signed outside of the foreign country by the foreign parent. In all cases the title to the property passed in the United States and a tax was imposed and collected by the United States. The contract manager was based in the U.S., made regular trips to the foreign country and stayed there for three or four weeks while he negotiated the contract. The taxpayer presented numerous copies of correspondence between the contract manager and the local subsidiary and the company trip log which showed the contract manager's frequent visits to the foreign country. The foreign government reviewed *all* of the telexes that went in or out of the foreign subsidiary and reviewed the personnel files of all people stationed in the foreign country. The U.S. taxpayer requested and met with the foreign government in the fall of 1983 and failed to convince the government to change its position. The tax assessment was based on an imputed profit on the sale by the U.S. parent, plus a number of additional penalties for late payment and failure to pay taxes. The assessment was approximately $20 million. Under the laws of the foreign jurisdiction, when the tax authorities made an assessment, the tax had to be paid within 10 days. Thereafter, the taxpayer had the right to dispute the matter.

The taxpayer met with the State Department (the appropriate foreign desk) and also with representatives of the IRS, including the Chief of the Tax Treaty and Technical Services Division. The meeting concluded with the suggestion that the U.S. taxpayer invoke the competent authority. As a result of reporting to the foreign authorities that the U.S. taxpayer was going to request competent authority, the foreign authorities were willing to grant a temporary postponement of the assessment of the tax and the payment that would automatically follow. In December 1983 the U.S. competent authority filed a request for competent authority with the foreign government and requested a statement of the foreign country's position. In early 1984 the U.S. sent its revenue agent representative, located in another country, to move the foreign competent authority to discuss the dispute. The representative took the position that an assessment requiring immediate payment would be inconsistent with the policy behind the treaty provision on competent authority and stated that the U.S. would look at it as an infringement on the treaty. The treaty partner delayed the assessment.

The taxpayer prepared a position paper answering the foreign government's positions, arguing that:

1. The office of the foreign subsidiary was not the office of the parent and supplying the evidence previously mentioned;
2. The foreign corporation was not a sham; it had an office, it had people, it had paid taxes and had received a letter of commendation from the country;
3. The foreign subsidiary was a dependent agent without the power to contract.

The preparation involved the usual litigation file, including a notebook showing exhibits, legal briefs, definition of permanent establishment in other treaties, etc. The taxpayer's material was submitted to the RAR who prepared his own submission for the competent authority. The taxpayer was extremely impressed with the U.S. RAR. As he stated, "it was like sitting down with your own counsel." In the fall of 1984 the U.S. response was filed with the foreign government.

76. This situation is not rare. An Australian–German competent authority proceeding was recently announced on a similar issue.

In October 1984 they had their first meeting. In November 1984 they had their second meeting resulting in a stalemate. The taxpayer had told the U.S.competent authority that while it would agree to settle on an additional amount of tax on its local subsidiary, it would not agree to settle on any basis that the U.S. parent had a permanent establishment in the foreign country. The U.S. taxpayer also insisted that any agreement reached would be binding for future years.

The foreign government responded with a proposal to tax the foreign subsidiary based upon its own prior internal procedures for calculating an agent's commission where there were no books and records and agreed to drop the penalties for those years, but collect interest. Because of the large interest involved, the taxpayer agreed only if the foreign government would assess the tax in the current years. The taxpayer was able to persuade the foreign government to drop all prior years and to impose a higher tax in 1984 which would convert the prior interest penalties to an additional tax. The foreign government agreed to this, but the U.S. objected to the telescoping of the earlier years into a later year as being contrary to U.S. policy. When the foreign government suggested that it would return to its position to assess the tax directly on the U.S. parent company, claiming it had a foreign permanent establishment, the U.S. taxpayer agreed to the compromise with the imposition of the tax in the years 1984 and 1985.

Settlement was finally agreed to by the U.S. competent authority who agreed with telescoping all the prior year taxes into 1984 and 1985 but did not agree with changing the interest that would otherwise have been due in prior years to a tax. The taxpayer yielded. The IRS conveyed its approval to the foreign government and it made a formal proposal to the U.S. Apparently it is the U.S.' negotiating position that the other country must always make the offer when the U.S. objects to an adjustment against a U.S. taxpayer. In this case no closing letter was prepared. The foreign authorities wrote a letter to the U.S. Foreign Operations Director who then forwarded the letter to the Domestic Operations Director. No official copy was sent to the U.S. taxpayer.

In this negotiation, the U.S. taxpayer's representative was permitted to have direct contact with the foreign authority as a representative of the foreign subsidiary. It could not meet as a representative of the U.S. parent since they were represented by the U.S. competent authority. The taxpayer's representative had received prior consent from the competent authority. Without it, it could possibly have jeopardized the availability of the competent authority under section 9.01(c) of Rev. Proc. 82-29.

EXHIBIT A

UNITED STATES COMPETENT AUTHORITY STATISTICS

Since 1 July 1971, the U.S. Competent Authority has received 951 requests for starting a taxpayer initiated mutual agreement procedure. On that date there were 8 allocation cases and 13 non-allocation cases in inventory. The total number of cases received and disposed of each year, the year-end inventory, and the average duration of a case are set forth in the following table:

TABLE A

Total cases received and disposed of

Fiscal year	*Total cases received*	*Total cases disposed of*	*Year-end inventory*	*Average duration (months)*
1971	41	34	28	15.73
1972	24	19	33	16.89
1973	36	18	51	17.22
1974	53	48	56	16.00
1975	51	37	70	15.05
1976	56	39	87	19.53
Trans.*	12	10	89	13.20
1977	80	50	119	16.62
1978	57	25	151	21.84
1979	42	63	130**	26.63
1980	100	65	165**	23.68
1981	77	55	187**	26.45
1982	96	90	193**	25.60
1983	83	109	167**	20.82
1984	74	73	168**	24.57
1985	69	66	171**	23.84
Total	951	801		

* Transition period from 1 July 1976 to 30 September 1976 resulting from change from 30 June to 30 September fiscal year.

** Included are 10 cases in suspense at the end of fiscal year 1979, 20 cases at the end of fiscal year 1980; 14 cases at the end of fiscal year 1981, 19 cases at 9/30/82, 10 at 9/30/83, 6 at 9/30/84, and 8 at 9/30/85.

Average duration of a closed case – from the date a case is received until the date a case is closed. This includes months that a case may be held in suspense as a result of a case being subject to review by the Joint Committee on Taxation. Average is based on cases closed during the period.

TABLE B

Allocation cases under Revenue Procedure 82-29/Initiated

Fiscal year	*Total cases*	*U.S./Foreign allocation*		*U.S. parent*	*Foreign parent*
1971	27	14	13	26	1
1972	12	6	6	11	1
1973	23	16	7	21	2
1974	34	25	9	34	–
1975	39	29	10	38	1
1976	28	18	10	28	–
Trans.	6	5	1	5	1
1977	45	33	12	45	–
1978	42	30	12	41	1
1979	28	20	8	25	3
1980	60	37	23	53	7
1981	50	24	26	46	4
1982	67	40	27	52	15
1983	53	20*	34*	47	6
1984	44	16	28	40	4
1985	43	22	21	40	3
Total	601	355	247	553	49

Tables C and D set forth the data on disposition of allocation cases and non-allocation cases, respectively, showing that approximately 66% of the allocation cases closed through FY 85 resulted in full relief and 54% of the non-allocation cases resulted in full relief. Partial relief was obtained in 8% of the allocation cases and 7% of the non-allocation cases.

* One case involves adjustments initiated by both the U.S. and the treaty partner.

TABLE C

Allocation cases under Revenue Procedure 82-29/Dispositions

		After negotiations			*Without negotiations*		
Fiscal year	*Total dispositions*	*Full relief*	*Partial relief*	*No relief**	*Full relief*	*Partial relief*	*No relief**
1971	11	6			4		1
1972	9	8			1		
1973	11	8		1			2
1974	28	19	3	2	1		3
1975	26	12	1		7		6
1976	25	15	4	2	1		3
Trans.	5	4					1
1977	22	9	2	1	3	1	6
1978	13	9			3		1
1979	38	27	1	1	2		7
1980	30	18	1	2	4		5
1981	37	21	2	4	2		8
1982	64	43	4	6	4		7
1983	79	37	15	3			24
1984(1)	45	41	5	5	3		5
1985(2)	35	23	1	4	4	2	15
Total	484	300	39	31	39	3	94

* The primary reasons for lack of relief were (i) the case was withdrawn by the taxpayer, (ii) relief was barred by the statute of limitations, (iii) there was no double taxation under the treaty, as in the case of U.S. taxpayer seeking a correlative adjustment because of an allocation of deductions by the IRS for U.S. foreign tax credit limitation purposes, (iv) there was a legal barrier such as the Canadian inability to allow a deduction for interest on a debt to an affiliate not evidenced in writing (see TIR-1294 6/4/74), (v) there was a procedural barrier such as a court decision or a closing agreement (and no treaty waiver), (vi) the request was premature, and (vii) the taxpayer failed to cooperate and supply requested information.

(1) During the fiscal year 45 allocation cases were closed. However, as a result of multi-country cases, 59 countries were resolved. The 59 countries include cases closed and countries closed where the case as a result of continued negotiations with other countries remain open.

(2) As in (1) above, 35 allocation cases were closed. However, as a result of multi-country cases, 49 countries have been resolved.

TABLE D

Non-allocation cases under Revenue Procedure 77-16/
Initiated and Dispositions

			After negotiations			*Without negotiations*		
Fiscal year	*Total received*	*Total disposed of*	*Full relief*	*Partial relief*	*No relief**	*Full relief*	*Partial relief*	*No relief**
1971	14	23	12	1	2			8
1972	12	10	6		2			2
1973	13	8	5		1			2
1974	19	20	8		3	3		6
1975	12	11	4		1	4		2
1976	28	14	2		5	1		6
Trans.	6	3	1	1	1			
1977	35	28	7				14	7
1978	15	12	6		4		1	1
1979	14	25	12		9			4
1980	40	36	30		2	1		3
1981	39	18	7	3	2	3		3
1982	29	26	15		3			8
1983	30	30	13	1	9			7
1984	30	28	12	1	10	1		4
1985	26	31	19	–	5	4	—	3
Total	362	323	159	7	59	17	15	66

* See note, Table C, for a description of the reasons for no relief. With non-allocation cases, item (iii) would be no treaty violation by the foreign treaty country.

** Currently unavailable.

TABLE E

Multiple country cases

		Number of countries in multiple cases						
Fiscal year	*Total Multiple cases*	*2*	*3*	*4*	*5*	*6*	*7*	*8 or more*
1971	1					1		
1972	2	1	1					
1973	1							1 (12 countries)
1974	3		1	1	1			
1975	5	4	1					
1976	3		1		2			
Trans.	—							
1977	7	5	1				1	
1978	8	5		2			1	
1979	5	2	1	1				1 (11 countries)
1980	8	5	1	1				1 (9 countries)
1981	4	2					1	1
1982	4	1	1		1	1		
1983	3	1			1			1 (13 countries)
1984	2		1					1 (8 countries)
1985	8	—	2	3	1	–	1	1 (9 countries)
Total	64	26	11	8	6	2	4	7

As computed from Table A, through 9/30/85, the historical average duration to close a Mutual Agreement Procedure case, computed from the time the case is received in the Foreign Operations District, is 22.17 months. It should be noted, however, that many cases have taken considerably longer, some requiring as long as five years to resolve. On the other hand, some cases have been resolved in a matter of months. The IRS is trying to reduce the average to 10 months from the time the case is fully developed in the U.S., but delay frequently results from causes beyond its control, such as the time it takes for taxpayers to provide additional data requested from them and for the foreign Competent Authority to respond to U.S. negotiating initiatives.

EXHIBIT B

CANADIAN COMPETENT AUTHORITY STATISTICS

TABLE 1

Competent Authority Operations Section
Summary of Cases, 1976-1984

	New cases	*Cases closed*	*Closing inventory*
1975-76	18	24	28
1976-77	28	16	40
1977-78	29	14	55
1978-79	30	18	67
1979-80	26	41*	52
1980-81	25	17	60
1981-82	37	22	75
1982-83	37	39	73
1983-84	48	51	70

* Twenty of these were on the same issue (section 20(11)) and were closed at the same time.

TABLE 2

Competent Authority Operations Section
Workload Analysis, year ended 31 March 1984

Inventory of cases	*Number*	*Percentage of total*
U.S. cases	59	84%
Other countries	11	16%
	70	
Cases with U.S.:		
Canadian-initiated	38	54%
U.S.-initiated	21	30%
Cases with other countries:		
Canadian-initiated	5	7%
initiated by other countries	6	9%
	70	

Year of request	*Total*	*Tentatively settled*	*Active*
1978	2	2	0
1980	1	1	0
1981	11	3	8
1982	12	2	10
1983	37	6	31
1984	7	0	7
	70	14	56

EXHIBIT C

EXAMPLES OF COMPETENT AUTHORITY AGREEMENTS

IRS publication	*Country*	*Nature of agreement*
Rev. Rul. 54-5	Canada	Allocation of income of buses operating across border
IRS Ann. 1956-12	France	Application of turnover tax to investors
Rev. Rul. 67-143 1967-1 C.B. 425	Switzerland	Definition of subsidiary corporations
Rev. Rul. 70-133 1970-1 C.B. 159	Austria	Treatment of Australian surcharge tax for purposes of U.S. foreign tax credit
Rev. Rul. 70-196 1970-1 C.B. 359	Japan	Definitions of "educational establishments" and "other educational institutions"
Rev. Rul. 72-437 1972-2 C.B. 660	Germany, U.K., Ireland, Netherlands, Finland, Trinidad, Tobago, Japan	U.S. will allow credit or refund despite expiration of statute of limitation to effectuate agreement between competent authorities and will allow reopening of a closing agreement
Rev. Proc. 74-14 1974-1 C.B. 436	Germany	Procedure for U.S. person to obtain German treaty benefits
Rev. Rul. 74-92, 1974-1 C.B. 373	Germany	Interpretation of income derived from "operation of ships" within meaning of Convention
Rev. Rul. 75-402, 1975-2 C.B. 511	France	Exemption from stamp taxes applies to over-the-counter transactions
Rev. Rul. 76-170 1976-1 C.B. 470	Japan	Debt obligation financed under the Medium Term Discount Program of U.S. Export-Import Bank is indirectly financed by such Bank within meaning of Treaty
Rev. Rul. 76-568, 1976-2 C.B. 492	Netherlands	Interpretation of income derived from "operation of ships" within meaning of Convention
Rev. Rul. 77-62, 1977-1 C.B. 414	France	Definition of "reinsurance premiums" within meaning of Convention
Rev. Rul. 77-269, 1977-2 C.B. 490	U.K.	Definition of commercial profits
Rev. Rul. 77-289, 1977-2 C.B. 490	Germany	Exemption from taxation for receipt of grants from non-profit organizations is not dependent on situs of organization
Internal Revenue News Release IR-82-70 28 May 1982	Canada	Competent Authorities will not consider requests for relief arising from recharacterization of equity as debt
Treas. Dept. Release 2/17/84	Canada	Taxation of offshore drilling rigs

EXHIBIT D

COMPETENT AUTHORITY STUDY GROUP QUESTIONNAIRE

A Competent Authority Study Group has been formed by the Internal Revenue Service to review various aspects of the Competent Authority Function. The purpose of this questionnaire is to help the group determine the reasons for the recent decrease in Competent Authority requests from U.S. taxpayers who have been subject to section 482 adjustments.

Your responses to this questionnaire should relate to your experience with international type adjustments affecting a country with which we have a tax treaty, or a possession with which we have a Mutual Coordination Agreement, e.g. Puerto Rico. You are encouraged to include a narrative response to any question which you believe is not sufficiently answered by a specific response.

Your response will be kept confidential under the provision of Title 26 USC 6103.

Please return the completed questionnaire to the Internal Revenue Service no later than 31 December 1984.

QUESTIONNAIRE

1. Which type of organization are you affiliated with?
 .... Law Firm .... Accounting Firm .... Corporate Taxpayer
 .... Public Interest Group .... Other
2. How many cases have you been involved with in which a section 482 adjustment with an entity in a treaty country was recommended?
 .... None
 1-3
 4-6
 .... More than 6
3. How many cases have you been involved with in which the taxpayer has requested competent authority consideration?
 .... None
 1-3
 4-6
 .... More than 6

4. At what stage were the most significant section 482 adjustments?

	Mostly	*Some*	*Rarely*	*None*
Examiner	....	....	....	....
Appeals	....	....	....	....
Competent Authority	....	....	....	....
Courts	....	....	....	....
District Counsel	....	....	....	....
Other	....	....	....	....

5. If resolved at the examiner level, what type of relief was provided?

6. If resolved at the appeals level, what type of relief was provided?

7. Was the taxpayer advised of the right to competent authority consideration?
.... Always .... Sometimes .... Rarely .... Never

8. Have you ever been involved in a case where a taxpayer was advised not to seek competent authority consideration?
.... Yes .... No If yes, please explain.

9. Have you ever been involved in a case where a taxpayer was asked to delay requesting competent authority consideration?
.... Yes .... No If yes, please explain.

10. How were the double taxation cases resolved that you were involved in?
.... Taxpayer filed claim for relief with treaty partner?
.... Always .... Sometimes .... Rarely .... Never
.... Taxpayer filed request for competent authority consideration.
.... Always .... Sometimes .... Rarely .... Never
.... Taxpayer was allowed a foreign tax credit under Rev. Ruling 76-508/80-231.
.... Always .... Sometimes .... Rarely .... Never

11. Using the reasons stated below, indicate the degree you would use them to recommend that a taxpayer not seek competent authority consideration.

	Always	*Mostly*	*Sometimes*	*Rarely*	*Never*
(a) Joint Committee case	....	....	....	....	....
(b) Treaty country reprisal	....	....	....	....	....
(c) Takes too long	....	....	....	....	....
(d) Could be detrimental to current or subsequent audit	....	....	....	....	....
(e) Better deal using other IRS administrative remedies	....	....	....	....	....
(f) No adverse tax affect on foreign sub	....	....	....	....	....
(g) Not willing to reveal confidential information to:					
Foreign Country	....	....	....	....	....
Foreign Sub	....	....	....	....	....
(h) Adjustment de minimis	....	....	....	....	....
(i) Too costly (time and/or money)	....	....	....	....	....
(j) Low tax rate in treaty country	....	....	....	....	....
(k) No reason given	....	....	....	....	....
(l) Other:	....	....	....	....	....
(m) Other:	....	....	....	....	....

12. Please indicate which of the following adjustments you consider de minimis:

	Under $ 10,000	*$ 10-25,000*	*$ 25-50,000*	*$ 50-100,000*
Interest	....	....	....	....
Royalties	....	....	....	....
Pricing	....	....	....	....
Rent	....	....	....	....
Intangibles	....	....	....	....
Services	....	....	....	....
R & D	....	....	....	....

13. Would an unfavorable decision by the Competent Authority preclude you from recommending that a taxpayer request competent authority consideration for a similar issue in a subsequent year?
.... Yes .... No If yes, why?

14. How familiar are you with Rev. Proc. 70-18, which established the initial Competent Autority procedure?
.... Very .... Adequately .... Somewhat .... Not at all

15. How familiar are you with Rev. Proc. 82-29 which revised and updated the Competent Authority procedure?
.... Very .... Adequately .... Somewhat .... Not at all

16. If you have read both Revenue Procedures, do you feel either one would discourage taxpayers from seeking competent authority consideration?
.... Yes .... No
If yes, which one(s) .... 70-18 .... 82-29 Why?

17. Would the recent revisions to Regulation 1.901-2(e)(5) affect your decision to seek competent authority consideration?
.... Yes .... No If yes, why?

18. Would you recommend that a taxpayer not request competent authority consideration if a specific country is involved?
.... Yes .... No If yes, which country and why?

19. If you recommend that a taxpayer not seek competent authority consideration and additional section 902 credits were disallowed, would you take the case to court? Why?

20. Based upon your experience, do you believe taxpayers have a negative attitude about competent authority?
.... Yes .... No
If you answered yes, list the three most important reasons for your response.
1.
2.
3.

The study group appreciates the time and effort you have given in responding to this questionnaire. If you have any additional comments or suggestions regarding the areas discussed above or with respect to any other areas involving the competent authority process not covered above, the study group would welcome them. Thank you.

Taxation of International Tourism in Developing Countries

By Charles Y. Mansfield*

I. INTRODUCTION

The emergence of international tourism as a significant economic activity has had striking consequences for a number of industrialized and developing countries. While tourism as a leisure occupation can be traced to ancient times, international mass tourism is a recent phenomenon that began with the introduction of commercial jet passenger service in the late 1950s. By the mid-1960s international tourism had begun to expand rapidly in developing countries. As air travel reduced transportation costs on the supply side, rising incomes and the wide-spread practice of paid vacations in industrial countries helped create a mass demand for international travel. Data on international tourism illustrate its rapid growth. By 1982, international tourist arrivals had risen to 280 million from 25 million in 1950. International tourist receipts, for which comprehensive data are available for more recent periods, rose from $ 18 billion in 1970 to $ 100 billion in 1982. Arrivals in developing countries had grown to 50 million in 1982 – up from 18 million just 12 years earlier. Tourist receipts in developing countries during the same period grew from $ 2.8 billion to $ 17 billion (Table 1). Clearly, international tourism is a growth industry in which developing countries have shared. For some, in fact, tourism has become a prominent source of foreign exchange earnings and contributes substantially to gross domestic product (GDP).

Table 1

International tourism: Arrivals and receipts

Year	*International tourist arrivals*	*Arrivals to developing countries*	*International tourist receipts*[1]	*International tourist receipts of developing countries*	*Percentage share of developing countries*
	(In millions)		*(In billions of US$)*		
1950	25.3	—	—		
1960	69.3	—	—		
1970	159.7	18.0	17.9	2.8	15.6
1971	172.2	20.1	20.9	3.1	14.8
1972	182.4	24.1	24.8	4.2	16.9
1973	191.3	25.4	31.3	5.5	17.6
1974	197.8	27.5	34.1	6.5	19.1
1975	215.1	27.8	38.6	6.7	17.4
1976	221.6	29.8	43.7	7.8	17.8
1977	239.9	31.9	52.4	9.0	17.2
1978	258.1	35.8	68.8	10.9	15.8
1979	268.1	39.3	81.8	13.4	16.4
1980	280.0	47.2	95.3	14.2	14.9
1981	283.6	50.2	96.0	16.0[2]	16.7[2]
1982	279.9	49.6	99.9	16.7	16.7

Sources: *International Tourism in Figures, 1970-1979*, and *Economic Review of World Tourism*, 1982 and 1984 editions published by World Tourism Organization, Madrid.

1. Excluding payment for international tourist fares.
2. 1981-82 estimated in conformity with previous definition of developing countries.

Contents

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* The views expressed represent the opinions of the author and, unless otherwise indicated, should not be interpreted as official IMF views. The author is indebted to David Nellor, Ved Gandhi, Milka Casanegra de Jantscher and Vito Tanzi for helpful comments.

An initial unquestioning advocacy of tourist development has changed, as critics are asking whether the benefits of tourism outweigh its costs, both on economic and broader social and political grounds. While economic analysis of tourism has centered on its costs and benefits to the economy as a whole, little work has been done on the impact of tourism on public finances, and particularly on taxation of tourism.

This paper will first examine characteristics of the tourist market – a topic that bears heavily on questions such as whether tourism should be taxed and how much. Some peculiarities of tourism as a potential tax base will also be considered. Within this framework, the paper will examine the actual tax practices of a sample of developing countries that rely heavily on tourism. Before proceeding it would be useful to define that part of taxation of tourism to be treated in this paper. Tourism, like any other economic activity, generates factor incomes (e.g. wages of hotel employees and profits of hotels) on which direct taxes can be levied. Tourism may also cause the value of real estate or other assets to appreciate. Such gains can be subject to property or wealth taxes or license fees. Tourism also yields revenue from indirect taxes such as customs duties and sales taxes levied on tourist sector inputs and on goods and services that tourists buy. Finally, tourist spending has a multiplier impact – tourist spending generates successive rounds of income, some of which is taxed by government.

Country data presented in this paper show that taxes on international tourism in developing countries have centered on tourist expenditure, as opposed to direct or indirect taxes on "producers" of tourist services. Estimates of revenue accrued from taxation by multiplier effects of tourist expenditure will not be treated in this paper because the intention is not to deal with the macro impact of the tourist sector. Typically, however, multiplier impacts are substantially reduced by a high propensity to import and because linkages between tourism and the local economy are often weak.[1]

II. THE INTERNATIONAL TOURIST MARKET

International tourism, like mineral or oil deposits, cannot be produced by any economy, but instead depends on an endowment of "touristic" qualities relating to its culture, history, climate, beaches, wildlife, or scenery. For the subgroup of tourist-endowed developing countries tourism presents intriguing prospects. In contrast to exports of such commodities as coffee, cocoa or tea, demand for international tourism is perceived to be income elastic (i.e. a growing share of expenditure from high-income countries may be spent on tourism). International tourism has also rebounded from the oil price increases of 1973-74 and 1979-80, implying a price-inelastic demand for international tourism. Quantitative estimates of income and price elasticities for foreign travel from major origin countries generally support these intuitive perceptions. In particular, since 1974 sharp fluctuations in exchange rates, in comparative rates of inflation, and in consumer incomes have caused corresponding fluctuations in international travel. These sharp fluctuations have made it easier to measure price and income elasticities for major origin countries. A summary of such measurements indicates that a 1% increase in real discretionary incomes results in an increase of between 1 and 1.5% in travel abroad, in terms of numbers of travelers or real expenditure. Price elasticity, except in Germany, appears to be generally lower than income elasticity. Typically a 1% increase in the relative cost of travel abroad from a particular origin country results in a fall of under 1% in travel abroad.[2]

While these estimates apply to foreign travel in general, developing tourist countries represent a small but significant segment of a vast tourist market. The potential international tourist to a developing economy might be thought of as making three sequential decisions: whether to travel domestically or internationally; whether to travel internationally to high-income developed countries (e.g. Europe, Japan, Canada, or United States) or low-income developing country tourist destinations; and, finally, which low-income developing tourist country to choose.

Although statistical estimates of domestic tourism are quite imprecise, there can be no doubt that domestic tourism far surpasses international tourism as an economic activity. The World Tourism Organization in Madrid calculated domestic tourist arrivals at 2.3 billion in 1981 compared with international arrivals of 284 million. The most recent edition of the *Economic Review of World Tourism* states that "domestic tourism expenditure amounts to between five and ten times international tourist expenditure".[3] The international tourist, then, is already a marginal participant in a much broader tourist market, and is affected by relative price changes between domestic and international tourism as well as by changes in his own income that lead him to more or less costly destinations.[4]

Turning to the international tourist market itself, data show that international tourism takes place largely among developed countries. Of the $ 92.5 billion spent world-wide during 1980 on tourism, $ 14.2 billion, or 15%, represents travel to developing countries (Table 2). Among developed countries, tourist flow is two-way; but in developing countries foreign visitors far outweigh nationals traveling abroad. Countries with high living standards and whose territories are relatively small, such as the Federal Republic of Germany, the United Kingdom, and France, are prototypes of tourist-generating countries. Larger countries with high standards of living, such as the United States and

1. Multiplier estimates and a survey of methodology are found in *International Tourism to 1990*, Robert Cleverdon and Anthony Edwards, Abt Books, Cambridge, Massachusetts (1982).
2. *International Tourism to 1990*, Robert Cleverdon and Anthony Edwards, Abt Books, Cambridge, Massachusetts (1982).
3. *Economic Review of World Tourism*, 1982 and 1984 editions, World Tourism Organizations, Madrid, Spain.
4. Regression analysis for major origin countries has identified changes in real discretionary income and in the cost of foreign vs. domestic travel as significant variables in explaining travel abroad. See *International Tourism to 1990*, op. cit., Section V.

Canada, generate high absolute numbers of international tourists, but compete more closely with their own domestic tourism. In sum, the tourist market for developing countries is a part of a much larger market that includes domestic tourism and tourism among developed countries. Developing tourist economies then compete among themselves for a relatively small fraction of world tourist expenditure.

Table 2

International tourism receipts, 1970-80

(In millions of U.S. dollars and percent)

	1970		1975		1980	
	Tourist receipts	*Percent of total*	*Tourist receipts*	*Percent of total*	*Tourist receipts*	*Percent of total*
United States and Canada	3,510	19.7	6,410	16.6	12,765	13.8
Europe	11,200	62.6	24,800	64.2	64,000	69.2
Australia, Japan, and New Zealand	420	2.3	691	1.8	1,572	1.7
Developing countries[1]	2,761	15.4	6,698	17.4	14,162	15.3
Total	17,900	100.0	38,600	100.0	92,500	100.0

Source: *International Tourism in Figures, 1970-80,* World Tourism Organization, Madrid.

1. Data on total tourist receipts from developing countries differ from Table 1 because of definitional changes and the use of more preliminary data.

While this view of the tourist market tends to emphasize its competitive nature, several academicians have offered a different view based on a comparison of the market for tourism and the market for export goods.[5] Indeed, their analysis would appear to have important consequences for tax policy. Tax analysis of traditional exports of developing countries, such as cocoa, tea, or rubber, assumes that these products are part of a largely homogeneous world market in which a single country exports only a small part of the world supply. In such a situation, a tax on the exported good will cut into the profits of home country producers and, in the long run, lead to lower investment and production of the exported good.[6] In contrast it has been argued that tourism is a more differentiated product, based on the fundamental factor of location in addition to historical, ethnic, and environmental differences. This argument implies that many tourist countries have locational and other advantages that enable them to enjoy a captive market which could be charged a price that includes an element of economic rent. A tourist country of this model would enjoy a loyal captive market and also attract "footloose" visitors who live farther away. For example, the Bahamas, which is located near a high-income, tourist-generating country (the United States), in 1983 received 85% of its visitors from that country.

While it is difficult on a priori grounds to choose between the competitive and differentiated product models, it is important to note that they have opposite implications for taxation. If a tourist country enjoys a degree of uniqueness in terms of location or other advantage, economic rent will exist and an important objection to the taxation of tourism will be removed. Taxing tourism would then be neutral with respect to the allocation of resources. In the real world one would expect to find a spectrum of tourist economies ranging from very competitive to quite unique. In looking at the possibility of taxing tourism, a fundamental point is to gauge the extent to which the country offers a differentiated product.

Without prejudging this issue it is clear that location plays a significant role when a consumer chooses among potential tourist economies, simply because transportation is an important part of the tourist expenditure package. Data on the origin of tourism from "sun and sand" tourist economies, as in the example of the Bahamas above, generally show that most visitors come from a nearby high-income, tourist-generating area. In a simple locational model economic rent would then accrue according to the proximity of the tourist economy. This locational model is difficult to apply to the real world, where tourist economies are not neatly located at varying distances from a high-income, tourist-generating area, and where favorably located tourist economies may compete among themselves. However, the locational model offers a basic insight that, other things being equal, taxation of tourism may be higher the closer the tourist economy is to a high-income, tourist-generating area. Simple locational advantage might then explain the higher rates of taxes on tourism in the Caribbean as a whole, as compared with tourist economies in, say, the South Pacific that are located farther from large, high-income population centers.

In more formal terms this distinction between the competitive and differentiated product views of tourism is shown in Figure 1. In Case 1 the long-run supply curve is level, representing a perfectly competitive tourist market until some point at which the finite supply of sun and sand islands reaches its end. At that point the long-run supply curve turns sharply upward. Given an inelastic demand for tourism, a tax adopted by all tourist economies would raise the price and total receipts from tourism. If one tourist economy alone attempted to raise its price, however, it would be unsuccessful. Case 2 shows an upward sloping, long-run supply curve, indicating the existence of economic rent, which is shown in the shaded portion of the diagram. If taxes on tourism are designed to fall on items for which demand is inelastic, such taxes would extract economic rent and could be imposed without

5. For a summary of academic writings and a conceptual framework of tourism, see Stanley Noval, *The Demand for International Tourism and Travel: Theory and Measurement* (Xerox University Microfilms, Ann Arbor, Michigan, 1975).

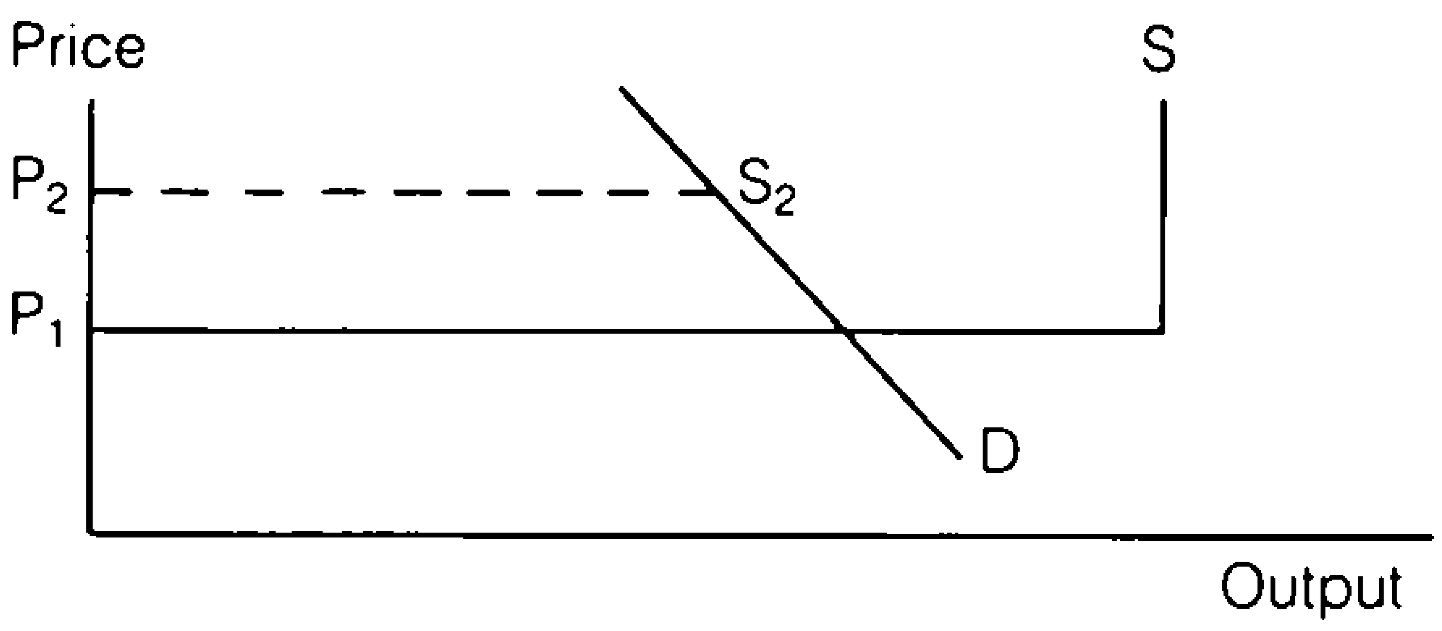
6. For a complete statement of this view see Richard Goode, *Government Finance in Developing Countries*, The Brookings Institution, Washington, D.C. (1984), pp. 176-180.

changing the price or output of tourism. Most tourist developing economies probably fall into the competitive category, while more unique tourist sites could claim to offer differentiated products.

Figure 1

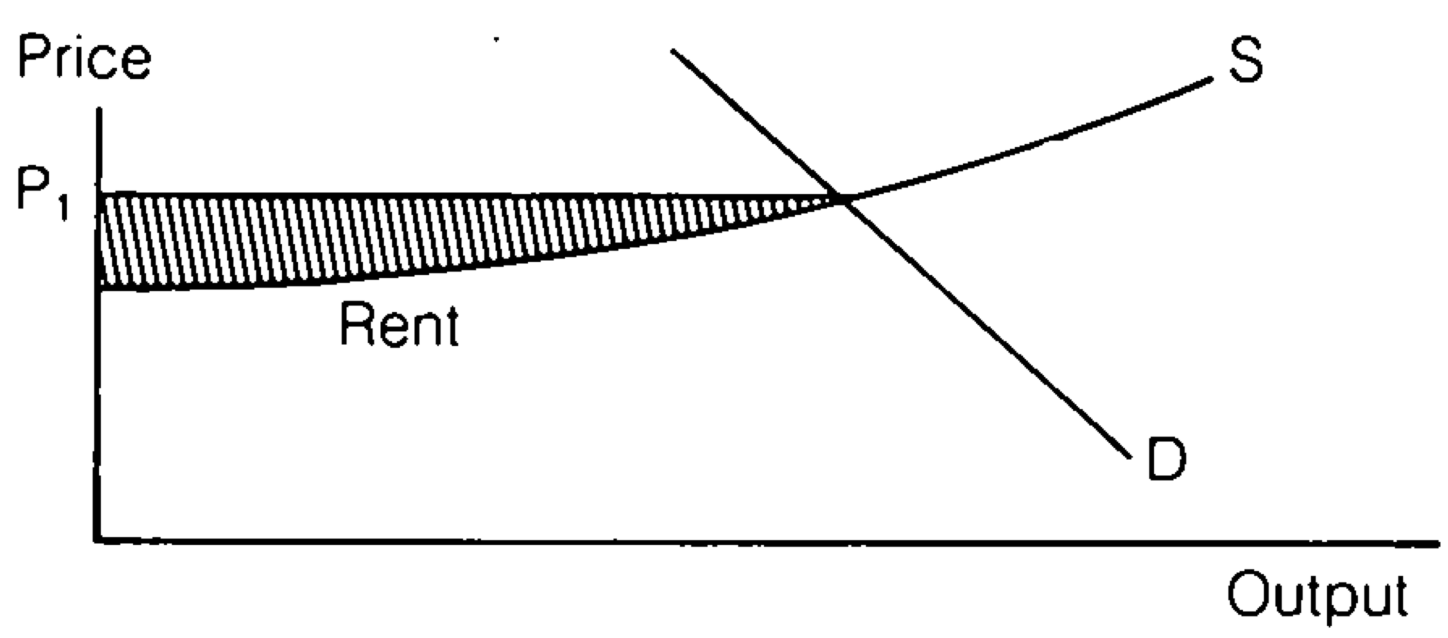
Tourist tax applied with and without economic rent

Case 1. Impact of tax in competitive market



P_1 = Price without tax
P_2 = Price with tax

Case 2. Impact of tax with differentiated product



P_1 = Price without tax or when tax falls only on rent

III. TAX HANDLES AND THE RANGE OF AVAILABLE TAXES ON TOURISM

On a more practical level, tourism presents an unusual situation with regard to the range of available taxes and the extent to which the potential tax base can be exploited. When taxation of tourism is compared with the taxation of traditional exports, one realizes that both producers and consumers of tourism could be taxed. Unless a country holds a monopoly on a product or has a large market share, only producers (not foreign consumers) of traditional exports can be taxed. In this sense the scope of taxes available to tax tourism is greater. In addition, because tourists are not voting residents the government is not constrained by equity considerations, such as the ability to pay, that might apply to its own residents. However, the nearly universal decision to subsidize the "producers" of tourism (i.e. hotels and related facilities) has effectively restricted the range of taxes available to the government in taxing tourism.[7]

This self-imposed limitation becomes clearer when taxation of tourism is compared with taxation of export goods. Exports of goods produced by residents are subject to income taxes, export duties, and marketing board arrangements. In fact, exports of such goods have historically been subject to high effective tax rates in many developing countries because they offer a convenient tax handle. Marketing boards for a number of export crops, for example, contribute large proportions of government revenue through profits made from buying crops from farmers at a lower price than that obtained from reselling in the world market. In addition, exports of goods are generally concentrated in specific localities or ports, where they can be checked by customs. Table 3 shows the importance of export duties as a percentage of total central government revenue in selected developing countries. In 11 countries export taxes accounted for between 17 and 36% of total government revenue.

By contrast, tourism offers an elusive tax base and a narrow range of tax choices. Tourists are not subject to income taxes and therefore must be taxed by expenditure-based or "head" taxes. Tourist expenditure, moreover, is fragmented and dispersed over a wide assortment of goods and services and takes place at many different localities and points of time. This dispersion of expenditure over space and time can present formidable problems of administration. Another conceptual difficulty in applying expenditure-based taxes is that tourist expenditure (i.e. the tourist tax base) should ideally be isolated from expenditure by the resident population, so that tax rates on tourist purchases could be determined according to the tourist's own elasticity of demand. The separation of tourist expenditure from resident expenditure is important

Table 3

Export duties as a percentage of total revenue of central government, selected developing countries

Country	*Years*	*Export duties as percentage of total revenue*
Ethiopia	1976-78	23.26
Rwanda	1978-80	25.42
Burundi	1975-77	22.16
Zaire	1978-80	18.58
Sri Lanka	1978-80	36.27
Ghana	1975-77	30.15
Honduras	1979-81	17.94
El Salvador	1978-80	28.36
Grenada	1975-77	17.00
Peru	1978-80	22.35
Malaysia	1977-79	19.59

Source: From Vito Tanzi, *Quantitative Characteristics of the Tax Systems of Developing Countries*, Departmental Memoranda, International Monetary Fund, 1983.

7. See below, however, for the example of Jamaica, where the Government has imposed taxes on hotels and related tourist enterprises.

because one can easily imagine that the degree of elasticity of tourist demand for a variety of goods and services would differ from that of resident demand. Ideally, one would wish to separate tourist purchases from resident purchases and tax each group at different rates. In practice this separation is only possible to a limited degree, and puts another constraint on potential exploitation of the tourist expenditure tax base. Empirical studies have shown, for example, that hotel charges, where tourist expenditures can be most easily separated from resident expenditure, account for only about one half of tourist expenditure.

Although tourist expenditure itself might be difficult to tax, one might tax instead residents who are the direct recipients of tourist expenditure. Again, however, incentives given for the purpose of developing tourism tend to block this alternative. Thus, the principal recipients of tourist expenditure – hotels – are widely granted effective exemption from income tax in developing countries. Practical obstacles to the taxation of tourism include, therefore, the fragmentation of the tax base (tourist expenditure); limits on the scope and variety of taxes available; and the difficulty of separating tourists and residents for purposes of taxation.

IV. AN EMPIRICAL VIEW: TAXATION OF TOURISM IN SELECTED DEVELOPING COUNTRIES

The aggregrate view of international tourism has focused on the world-wide growth of tourist spending, the question of whether and to what extent tourism is a differentiated product giving rise to economic rent, and the practical difficulties of taxing tourism. In this section, the growth of tax bases in a sample of touristic developing countries is examined, along with the taxes actually imposed on tourism. The revenue yield and buoyancy of tourist taxes are assessed, as well as the recent tendency to raise tourist taxes. Fiscal incentives to tourism and the growth of duty-free shopping are seen as part of an overall strategy toward tourism, of which taxation is a part.

1. Taxes imposed on tourism

Taxes imposed on tourism reflect the limited tax handles available, constraints on the type of taxes that can be imposed, and the difficulty of isolating the tourist population from residents. The latter point touches on just how one is to define a tourist tax. Ideally, a tourist tax would not touch the resident population. If it were possible, for example, a model tourist tax would fall on total tourist expenditure. Reality, however, departs from this ideal. To begin with, an important part of the tourist's own expenditure (i.e. transportation costs from the home country to the tourist site) is effectively excluded from taxation by developing countries because tickets are generally purchased at origin and carriers are typically foreign. In fact, data on tourist expenditure customarily exclude international transportation costs to the tourist site.

Table 4

Tax rates on hotel occupancy charges

Country	*Rate*
Jamaica	– US$ 12, US$ 10, and US$ 8 daily for categories A, B, and C, respectively (winter season). – US$ 8, US$ 6, and US$ 4 daily for categories A, B, and C, respectively (summer season).
Kenya	15% when charges include only room, or room and breakfast. 10% in all other cases.
Fiji	5% on hotel rooms, food, and drinks.
Grenada	7.5% on hotel rooms, food, and drinks.
St. Vincent and the Grenadines	5% on payments to hotels or the supply of refreshments.
St. Lucia	7% on hotel rooms, food, and drinks.
Dominica	10% on hotel room and liquor and tobacco sales.

Source: Budget documents of national authorities.

Thus, the potential tax base for tourism includes all tourist expenditure within the country. At one extreme some of this expenditure is undertaken exclusively by tourists, and taxation of such expenditure would fall (at least initially) exclusively on the tourist population. Data on tourist expenditure within the tourist country indicate that hotel accommodation is the largest single item, and is also an expenditure for which the tourist population can be effectively isolated. In addition, a hotel tax is easy to administer. Thus, it is not surprising that the common "tourist tax" is a tax on hotel accommodation. Other expenses at hotels, including food, beverages, and incidentals, also fall largely on the tourist population, so that the hotel room tax is often expanded to cover the complete hotel bill. Examples of this basic tourist tax are shown in Table 4.

For Jamaica the hotel tax consists of a substantial specific tax denominated in foreign exchange payable by the operator/owner of the hotel per guest night. This tax rate was doubled in the 1984/85 Budget. In Kenya the hotel accommodation tax for room or room and breakfast is 15% for tourists and 10% in all other cases. The Fiji hotel turnover tax, applied to room charges, food, and beverages, was 3% before 1984 and raised to 5% in the 1984 Budget. Among other tourist economies, Grenada has a 7.5% tax on hotel rooms, food, and drinks; St. Vincent and the Grenadines tax hotel accommodation and the supply of refreshments at 5%; and St. Lucia taxes hotel revenue derived from room charges, food, and drink at 7%.

The hotel tax is customarily assumed to fall on tourists (the consumers), inasmuch as their demand is assumed to be inelastic. However, package tour operators abroad in a competitive market could be forced to absorb the tax. In addition, market conditions involving substantial competition among hotels in a tourist country or among different tourist countries could lead to absorption of the tax by owners.

A less purely tourist tax is the embarkation fee, which is usually a specific amount. This tax generally applies to both residents and tourists. In Jamaica the travel tax amounts to J$ 20 (US$ 4.35) per person after several recent increases. The tax is payable by all travelers to destinations outside Jamaica. This tax is not a tax on expenditure itself, but rather in the nature of a "head" tax on residents and tourists, sometimes justified as a user fee for airport maintenance. Again, its main advantage is ease of administration. For Kenya, a similar air passenger tax is collected by the airlines on all passengers embarking at an airport on an external ticket. The charge is 100 K Sh (US$ 6.42) per passenger. Grenada similarly has an embarkation tax of EC$ 5.00 (US$ 1.85) per person. St. Lucia has an airport departure tax of EC$ 6.00 (US$ 2.22) for destinations within CARICOM and EC$ 12.00 (US$ 4.44) elsewhere. Hong Kong has a much higher embarkation tax of approximately US$ 15.00.

Beyond these two basic "tourist taxes" one begins to move into an area in which the tax falls predominantly on tourists, but at least in part on residents. Such "quasi-tourist" taxes fall on a range of services, such as restaurants, entertainment, and international telephone and telecommunications. When compared to the hotel and embarkation tax, the quasi-tourist taxes on restaurants and entertainment are more difficult to administer as they typically involve smaller and more numerous establishments. In a relatively populous tourist economy with a sizable local middle and upper class, taxes on this range of services would be paid in significant amounts by residents, whereas in a smaller economy with a larger percentage of poor people the tax burden would fall almost exclusively on tourists. This distinction is important because the elasticity of demand for the resident and the tourist would be expected to be quite different. A tourist with a given length of stay, less information, and a higher income level might have a more inelastic demand for services such as restaurants and entertainments, and would in theory be willing to pay much higher tax rates than a resident. In practice, however, the two populations – residents and tourists – cannot be effectively separated for this purpose.

Examples of such quasi-tourist taxes include Jamaica's entertainment duty levied on admission tickets for cinemas, horse races, shooting competitions, and bicycle races. This tax is levied at various rates, from 8⅓ to 16⅔% of the purchase price. Kenya similarly has a betting and gaming tax with varying rates and an entertainment tax levied on entrance charges of approximately 15% of the purchase price. Fiji introduced in the 1984 Budget a turnover tax on miscellaneous services such as videotapes, admission fees to night clubs, drinks and meals in bars, hotels, clubs, and licensed restaurants, hire charges for rental cars, and bets placed through licensed restaurants. The rate of this tax is 5%. Elsewhere, Grenada taxes cinema tickets at 15-20% of their price.

Another "quasi-tourist" tax is that on telephones and telecommunications. This tax is not as prevalent as the basic hotel and restaurant taxes. Jamaica has experimented with a tax on international telephone calls but the tax was rescinded because tourists began to call collect and revenue collapsed. A telecommunications tax also exists in Kenya, and Grenada taxes telephone calls outside the country.

While the above taxes are aimed primarily at the tourist population a third category of "tourist taxes" would include taxes paid by tourists but falling primarily on residents. This category would include imports, sales, and excise duties. Again, the issue here is that the tourist may have a more inelastic demand for these goods and could in theory be taxed at a higher rate to the extent that the resident and tourist populations could be separated. In practice, however, these goods are taxed by undifferentiated rate sales, imports, or customs duties, because there is no way to separate effectively the rates for tourists and residents. An estimate of the importance of this category of tourist taxes was made for Fiji, where they were found to account for nearly a third of tax revenue falling directly on tourists. In tourist economies with higher rates on basic tourist taxes this proportion would presumably be smaller.

Finally, mention must be made of duty-free goods available to tourists. In this case the tax on tourists is zero and is part of an inducement to tourists to come to the country. Administration of duty-free areas is designed to separate the tourist and resident populations. Administration varies from strict systems where goods are delivered to bonded areas or to international flights to more informal systems requiring some type of identification that the buyer is a tourist. In Europe tourists are allowed to buy gasoline at lower prices, and rebates from value added tax for purchase by tourists are given in France and the United Kingdom. As an example of the difficulties of administering an informal system, in Fiji duty-free imported goods (for which actual duties range from 0 to 10%) are sold in shops presumably frequented mainly by tourists, but

Table 5

Taxes imposed on tourists

Type of tax	*Population paying tax*	*Ease of administration*
Pure tourist taxes		
Hotel tax and embarkation fee	Almost exclusively on tourists	Easy to administer
Quasi-tourist service taxes		
Restaurant Entertainment International telephones	Mainly on tourists	More difficult to administer
Taxes on ordinary goods		
Sales, customs, and excise taxes	Mainly on residents	More difficult to administer
Zero taxes on tourists		
Duty-free goods	In theory exclusively on tourists	Difficult to separate tourist and resident populations without formal procedures

Table 6

Growth of tourist expenditure as a tax base: selected developing countries

	(In millions of SDRs)				Annual average increase (In SDRs)			Annual average increase (In local currency)
	1969	1974	1979	1982	1969-82	1974-75	1978-79	1969-82
Bahamas	—	272.7	434.6	605.8	10.2	− 5.5	9.9	9.1
Fiji	21.2	62.9	96.3	138.5	15.5	− 2.2	15.9	13.5
Dominican Republic	17.7	44.5	95.9	241.0	22.0	8.7	30.1	23.0
Costa Rica	17.4	40.3	57.1	120.2	16.0	5.7	− 1.2	32.0
Haiti	5.4	15.4	50.1	72.1	22.0	16.9	15.7	21.0
Jamaica	93.5	110.8	151.2	304.5	9.5	− 4.5	28.9	17.0
Kenya	—	62.9	134.8	203.8	12.1	19.1	1.1	17.1
Morocco	121.0	197.0	332.0	373.0	9.1	23.9	5.1	11.7
Nepal	—	—	34.7	57.3	21.0	—	28.8	23.0
Panama	65.3	101.0	126.1	155.8	6.9	−20.6	7.0	7.7
Peru	40.0	80.0	146.0	292.0	16.5	− 6.3	29.2	51.0
Philippines	40.0	48.0	184.0	407.0	19.5	87.5	9.5	29.0
Sri Lanka	2.9	11.8	52.5	116.6	33.0	22.9	37.1	63.0
Thailand	85.0	155.0	425.0	940.0	20.0	16.8	21.8	22.0
Tunisia	54.0	158.0	466.0	563.0	19.8	59.5	36.3	22.0

Source: *Balance of Payments Yearbook*, International Monetary Fund.

Table 7

Effective tax rate on exports: selected developing countries

	1979-81
Ghana	25.7
El Salvador	12.1
Zaire	14.9
Rwanda	39.1
Sri Lanka	22.5
Burundi	21.6
Ivory Coast	7.7
Malaysia	10.9
Guatemala	8.4
Guyana	17.9
Sierra Leone	9.8

Sources: For revenue data, *Government Finance Statistics*, International Monetary Fund. For export data, *International Financial Statistics*, International Monetary Fund. Data for Rwanda, 1980-81; for Ivory Coast, 1980; and for Burundi, 1979-80.

also by residents. These goods include consumer durables such as perfume, jewelry, cameras, shavers, calculators, televisions, radios, stereo equipment, and videotape recorders. A significant proportion of the purchases of these goods, which ordinarily would be subject to high import duties, is made by residents. Thus, without a strict system of delivery to bonded areas, duty-free systems can be abused with residents taking advantage of lower tax rates.

An overview of taxes imposed on tourists is given in Table 5. As this table illustrates, tourist taxes tend to be relatively uniform in different economies. This uniformity is apparently due to the constraints on tax handles and types of taxes that can be imposed. In addition, tourist taxation is relatively recent, and tourist economies may copy each other in choosing taxes. The similarity of taxes on tourism contrasts with the wide variety of taxes on exports of goods.

2. Growth of tourist tax bases

The growth of potential tourist tax bases (tourist expenditure within the country) is shown in a sample of tourist developing countries in Table 6. These country data bear our the aggregate data which show that while tourism is a growth industry in a number of developing countries, it is subject to fluctuations based on economic activity in major origin countries. For the sample as a whole the annual average increase of tourist expenditure measured in SDRs for the period 1969-82 was 17% – a much higher figure than growth in GDP for the same period. If the data are measured in local currency, the average annual increase in tourist expenditure is 24%. (A number of the countries – Costa Rica, Jamaica, Kenya, Peru, the Philippines, and Sri Lanka – underwent substantial currency devaluations during the 1969-82 period.)

The growth of tourist expenditure within tourist developing countries is especially impressive in view of the fact that during 1969-82 two oil price increases took place. More expensive oil sharply increased the transportation costs of international tourism. The initial oil price increase resulted in much lower rates of growth for tourism in 1974-75 for most countries in the sample, and even negative rates for five countries. The second oil price increase had a lesser impact in lowering growth rates for tourism in most sample countries. The resumption of growth in tourism after each of the oil shocks implies a price-inelastic demand for international tourism in the developing countries in our sample.

3. Revenue yield and burden of tourist taxation

Revenue yields from tourist taxes can be expressed as a percentage of the potential tax base, indicating the effective rate of taxation of tourist expenditure. Revenue from tourist taxes can also be compared to total tax revenue to indicate the dependence of the revenue system on taxation of tourists. From both perspectives, taxes on tourist expenditure are quite modest, particularly when compared with export taxes on goods.

Table 8 shows the effective tax rate on the base of tourist expenditure for a diverse group of developing economies. The effective rate of taxation is expressed as a percent of the potential base in both U.S. dollars and local currency because the currency of Jamaica and Kenya depreciated substantially in the last decade. In general, the table shows that effective tax rates are quite low, although they have risen in the last decade. Using U.S. dollars as a tax base, the effective tax rate in Jamaica has risen from 2.9 to 6.3% between 1972 and 1983, whereas in Kenya the comparable effective rate remained relatively constant at 9%. In both countries, however, when the tax base is expressed in local currency, the effective tax rate declined, indicating that revenue yields from tourist taxes did not keep pace with the depreciation of the local currency. Other effective rates for the latest year available were Fiji, 2%; the Bahamas, 3.7%; Barbados, 6.3%; St. Vincent and the Grenadines, 1.2%; and St. Lucia, 2.7%.

As a comparison to these effective rates for tourism, the effective rates on commodity exports for a group of commodity exporting countries are shown in Table 7. Relating export tax receipts to the potential base, the effective rate on commodity exports averaged 17.3%, and ranged as high as 39%. In a comparison of the dependence of the revenue system on tourist taxes with commodity export taxes, a similar contrast emerges. Tourist taxes as a percent of total tax revenue are 1.7 for Jamaica; 2.6 for Kenya; 1.4 for Fiji; 0.9 for St. Vincent and the Grenadines; and 3.2 for St. Lucia. Somewhat more significant proportions are found in the Bahamas (10.6) and Barbados (5.6) (Table 8). As noted earlier, commodity export taxes as a percentage of total revenue ranged from 17 to 36% in a group of commodity exporting countries.

Despite the relatively low level of taxation of tourism, tourist taxes show a rising trend in recent years. The trend is particularly striking in Jamaica: the 1984/85 Budget included a doubling of the hotel room tax, a doubling of the travel tax on tourists leaving Jamaica, a tax on the sale of U-drive vehicles, a tax on villas in lieu of property tax, and the introduction of substantial license fees on hotels and duty-free shops. In Fiji, the 1984 Budget included an increase in the hotel turnover tax from 3 to 5%; and the introduction of a turnover tax on miscellaneous services such as admission fees to night clubs, expenditures at bars and restaurants, rental car charges, and bets at licensed casinos. Rates on the basic tourist tax on hotel accommodations have risen in recent years in other tourist countries. The stimulus for these increases is clearly the rising trend of fiscal deficits and consequent pressure to increase revenue.

4. Fiscal strategy towards tourism

Taxation of the tourist population represents one facet of a fiscal strategy towards the tourist sector. Complementing the generally low taxation of tourists, developing countries have typically subsidized the tourist sector through tax exemptions and other fiscal incentives to hotels and related enterprises. The most common form of legislation in a developing country is a Hotel Aids Act, generally introduced in the 1950s, granting duty-free entry of building materials and equipment for hotel construction and operation to approved license holders, as well as exemption from income, property, and profits taxes for periods of about ten years.

Since fiscal incentives are not our central theme a thorough assessment is not attempted here. Selected examples, however, convey the generosity of fiscal incentives toward the tourist sector. In Dominica, the Hotels Aid Ordinance and Income Tax Act combine to provide a ten-year exemption from customs duty and income tax for hotels of at least six rooms. In practice, exemption from consumption tax or inputs is frequently included when a license for tax holidays is granted to an enterprise. In Fiji, hotels are given important income tax concessions. Under the Hotels Aid Ordinance, a hotel owner may deduct 55% of capital expenditure (less the cost of land) against annual chargeable income earned from the hotel or extension until claimed in full. If not used within five years, this concession can also be used to reduce profits of any other hotel operated by the taxpayer. Hotel companies may also claim an ordinary depreciation allowance on the full capital expenditure for buildings and equipment in addition to the 55% investment allowance. Alternatively, the hotel owner may receive a cash subsidy of up to 7% of the approved capital expenditure. The net expenditure after the set-off of subsidy may be written off entirely within 15 years. Hotel owners may also take advantage of incentives involving accelerated depreciation.

While such examples could be multiplied throughout the developing world, expert opinion has generally held that subsidization of tourist producers has been overdone. As a recent study concluded, "most Caribbean islands seem to have been so anxious to attract investors in the hotel sector that they have granted concessions for prolonged periods without questioning the suitability of location, economic viability, phasing, employment effects . . . or appropriateness of type or size of hotel to be built. Some exceptional cases do exist where hotels have forfeited their concessionary privileges or where applications have been refused. However, most hotels in the Caribbean seem to have been built with assistance from incentives legislation. Bermuda alone has never introduced legislation granting general concessions to hotels. Bermuda has been successful in attracting hotel development over a number of years, which casts doubt on the wisdom of the Caribbean islands, in giving rather indiscriminate assistance to developers and investors who might have been attracted to the region in any event and thus could have contributed more to the local economy through taxation".[8]

5. Tourist taxation as a revenue source

This survey of tourist taxation has shown that the tourist sector is generally lightly taxed.[9] The effective rate of taxation to total tourist expenditure is typically low, and tourist producers (e.g. hotels) are generally granted exemption from income and property taxes as well as indirect taxes on inputs such as imported raw materials and capital equipment. Nevertheless, taxes on hotel accommodations and on other tourist expenditures have been increasing recently in response to revenue demands. An important policy question, then, is to what extent taxation of tourism could be increased in response to an overriding need to reduce

8. *Incentives to Tourism in the Caribbean Region*, A Study for the World Bank by the Shankland Cox Partnership, London (1974).

9. As noted above, the measures of tourist taxation do not include indirect "multiplier" effects of tourist spending on revenue. Because of the limited linkages between tourism and the rest of the economy in developing countries, these indirect effects are not likely to be significant.

Table 8

Tourist taxes compared with tourist expenditures and total tax revenue

	1972/73	1973/74	1974/75	1975/76	1976/77	1977/78	1978/79	1979/80	1980/81	1981/82	1982/83	1983/84	1984/85
Jamaica													
Tourist taxes as percent of tourist expenditure in local currency	3.4	3.1	3.3	3.4	5.9	15.1	8.7	2.9	2.6	3.0	3.3	1.9	....
Tourist taxes in local currency as percent of tourist expenditure in U.S. dollars	2.9	2.8	3.0	3.1	5.4	13.8	14.7	6.3	4.7	5.3	5.8	6.3	....
Tourist taxes as percent of total tax revenue	1.3	1.1	1,1	0.9	1.0	3.2	3.1	1.5	1.3	1.4	1.4	1.7	....
Kenya													
Tourist taxes as percent of tourist expenditure in local currency	—	—	21.1	16.6	17.5	14.4	13.7	16.9	18.5	16.9	12.9	—	....
Tourist taxes in local currency as percent of tourist expenditure in U.S. dollars	—	—	9.2	8.0	8.5	7.0	6.6	8.2	8.9	10.1	9.1	—	....
Tourist taxes as percent of total tax revenue	—	—	3.0	2.6	1.8	1.4	1.4	2.1	1.8	2.7	2.6	2.6	....
Fiji[1]													
Tourist taxes as percent of tourist expenditure in local currency	—	—	—	—	—	—	—	—	—	2.2	2.0	—	....
Tourist taxes as percent of total tax revenue	—	—	—	—	—	—	—	—	—	1.3	1.4	—	....
Bahamas[1]													
Tourist taxes as percent of tourist expenditure in local currency	4.9	4.7	4.2	4.2	4.3	3.6	3.7	4.6	4.2	3.7	3.5	3.7	....
Tourist taxes as percent of total tax revenue	15.6	15.1	13.3	13.7	12.9	11.2	11.4	13.0	11.8	11.0	10.6	10.8	10.6
Barbados[1]													
Tourist taxes as percent of tourist expenditure in local currency	2.7	1.9	2.4	3.3	3.2	3.8	4.0	3.9	5.4	4.4	3.9	5.5	6.3
Tourist taxes as percent of total tax revenue	3.6	2.4	2.7	3.3	3.2	4.2	4.6	5.1	5.6	4.8	4.5	5.5	5.6
St. Vincent and the Grenadines													
Tourist taxes as percent of tourist expenditure in local currency	—	—	—	—	—	—	—	1.4	1.3	1.2	1.1	1.2	....
Tourist taxes as percent of tax revenue	—	—	—	—	—	—	—	1.4	1.6	1.2	0.8	0.9	....
St. Lucia													
Tourist taxes as percent of tourist expenditure in local currency	—	—	—	—	—	—	—	3.9	2.7	2.7	2.1	2.7	....
Tourist taxes as percent of tax revenue	—	—	—	—	—	—	—	5.2	3.8	3.5	2.5	3.2	....

Source: Budget documents of national authorities.

1. Comparable data not available for earlier years.

the fiscal deficit. In addressing this question both taxation of tourist expenditure and of tourist producers should be considered.

With regard to taxation of tourist expenditure, two possibilities for increased revenue exist. First of all, rates of existing taxes on hotel accommodations could be raised. Secondly, taxes could be imposed on tourist expenditure that has escaped the tax net. The advisability of raising taxes on tourist expenditure in a given country depends on its elasticity of demand. If demand is judged to be inelastic, tourist taxes could be raised to produce more revenue. Empirical work on this topic has been limited to tourist behavior in major origin countries. Measurements have been made of the cross price elasticities of demand for tourist travel (i.e. the extent to which tourists respond to changes in price between one destination and another). After an analysis of data on tourists leaving the United Kingdom, the United States, the Federal Republic of Germany, France, and Japan, a recent study concluded that there is evidence that travelers switch their pattern of travel between destinations in response to relative changes in costs. For the United Kingdom switching was found among European destinations in response to changes in relative prices, with elasticities averaging around -2.8%. A similar average cross price elasticity was found for Americans traveling to areas such as Canada, Mexico, West Indies, Central America, Europe, the Mediterranean and other destinations. A current example of response to price incentives is the booming travel from the United States to Europe, based on the appreciation of the U.S. dollar.

Given ample evidence of price responsiveness in travel behavior it would appear that the basic hotel and accommodations tax for a given country should not be far out of line with its neighbors, after allowing for differences in tourist "quality" among countries. This conclusion would hold whether the incidence of the tax is assumed to be shifted forward to the foreign traveler or absorbed by tour operators or hotels. A possibly more rewarding avenue for increased revenue would be to raise taxes on tourist discretionary expenditure that falls outside the package tour essentials. Revenue measures of this type could include taxes on restaurants outside hotels, local travel tours and car rentals. If these items are perceived by the tourist as discretionary expenditure outside the basic package by which tourist destinations are compared, demand may then be more inelastic.

Since taxation of tourist expenditure is limited by the competitive nature of the tourist trade, taxation of tourist producers could be considered as a more promising alternative. Presently tourist hotels and related enterprises are granted exemption from direct taxes on profits, windfall gains on property, and indirect taxes on imported inputs. In the face of an overriding demand for revenue these concessions could be tightened: tax holidays and income tax exemptions could be limited, property taxes could be applied, and customs duties could be applied to inputs. Such changes, even if existing legislation were altered for new entrants, would reduce the current subsidy to tourist producers. Assuming that tourist producers largely absorbed the new taxes, the competitive position of the country would not be changed.

V. SUMMARY AND CONCLUSIONS

International tourism is a recent, rapidly growing economic activity in which demand stems primarily from high-income, tourist-generating countries. The tourist market is dominated in numbers and expenditure by domestic tourism and foreign tourism among high-income countries. Although marginal players on the world tourism scene, developing countries have participated to the extent that tourism accounts for a high share of foreign currency earnings in a subgroup of "touristic" developing countries.

An important question concerning the world tourist market is to what extent an individual tourist country, and especially a developing tourist country, offers a differentiated product to which economic rent could accrue. This question bears directly on the possibility of taxing economic rent. Although isolated examples of unique tourist attractions undoubtedly do exist, the size and variety of the tourist market indicate that it is generally very competitive, and especially so with regard to the "sun and sand" resorts that make up much of the tourism of developing countries.

Empirical examination of touristic developing countries bears out this conclusion, as effective tax rates on the tourist expenditure base are generally quite low. Taxation of tourism thus offers an interesting contrast to the heavier burden of taxation on traditional export commodities such as cocoa, coffee, and tea. In addition to the perception of tourism as a competitive product, the relatively low taxation of tourism may reflect difficulties in taxing the tourist base. Unlike export commodities which offer a good tax handle, the tourist expenditure base is fragmented and sometimes difficult to isolate from resident expenditure. "Producers" of tourism (hotels and related facilities) are typically exempt from direct and indirect taxes. A typical spectrum of tourist taxes includes a hotel tax falling primarily on tourists, taxes on services falling in part on residents, taxes on sales and imports falling mainly on residents, and duty-free or zero-rate taxes on tourists. An inherent administrative constraint on effective tourist taxation is that the tourist population cannot always be effectively separated from the local population for tax purposes. If the tourist population could always be separated, tax rates paid by tourists might be set higher for goods and services for which tourist demand is inelastic. In practice, however, it may be difficult to separate the two populations.

When taxation of tourism is considered together with other fiscal policies toward the tourist sector, a clear pattern of subsidization of tourism is seen in contrast to the often heavy taxation of exports of traditional commodities. In the typical tourist economy the most direct recipients of tourist expenditure – hotels – are virtually exempt from income and property taxes through fiscal incentives such as tax holidays and rapid depreciation allowances. Inputs for hotel construction and maintenance are also typically exempt from taxation. Although the present policy leans toward subsidization it must be said that the rates and scope of tourist taxation have been increasing recently, probably owing to the pressure of reducing fiscal deficits. If more revenue is needed from the tourist sector, such revenue should stem mainly from reducing subsidies given to producers instead of raising rates on tourist expenditure.

INTERNATIONAL FISCAL ASSOCIATION NEWS

Some Highlights from the Secretary General's 1985 Annual Report

Presented at the New York Congress 1986

Prof. Dr. J.H. Christiaanse

IN GENERAL

The Secretary General, Prof. Dr. Jan H. Christiaanse, paid homage to the outgoing President of IFA, Mr. Max Laxan, whose unique merits were rewarded by his appointment as an Honorary President of IFA. Prof. Christiaanse welcomed Mr. Richard M. Hammer, who will chair IFA in the next term. The long promised questionnaire was enclosed in the 1985 Yearbook, the replies to which will be used to determine IFA's future course. Persons who have not yet filled out the questionnaire are urged to do so as soon as possible. Ever increasing Congress fees have been worrying IFA for a long time. However, the U.S.A. Branch has done its best to keep the 1986 Congress fee within reasonable limits and the Brussels Congress in 1987 will probably be able to reduce the fees to some extent.

Following the 1985 London Congress the U.K. Branch of IFA made a generous donation to IFA of US$ 16,000 in order to set up a permanent fund for the Mitchell B. Caroll Prize (see below).

LONDON CONGRESS

The 39th IFA Congress was held in London in the new Barbican Centre. It was a large Congress attended by 1,376 participants and 734 accompanying persons. Despite this large number of persons it was an impressive manifestation and IFA is particularly indebted to Messrs. D.F.A. Davidson, President of the Congress, J. Hickman, Congress Secretary and J.S. Phillips, Congress Treasurer. Breaking with a long tradition, the Opening Ceremony took place on Sunday evening, instead of on Monday morning, followed by an informal reception. The opening address was given by Mr. Ian Gow, M.P., Secretary of State for H.M. Treasury.

Mr. R.T. Esam (U.K.) chaired the working session on Subject I – "*The assessment and collection of tax from non-residents*", Mr. D.R. Tillinghast (U.S.A.) acted as the Discussion Leader, Messrs. M.H. Collins and J.S. Phillips (U.K.) were the General Reporters and Mr. M. Gammie the Secretary. Messrs. L.F. Teixeira Pinto (Brazil), Prof. DDr. H.G. Ruppe (Austria), Dr. M. del Giudice (Italy) and R. Pennone (Switzerland) were the Panelists.

Mr. D.A. Clarke (U.K.) chaired the working session on Subject II – "*International double taxation of inheritances and gifts*"; Mr. R. Koch-Nielsen acted as its Discussion Leader, Mr. W.D. Goodman (Canada) as General Reporter, and Mr. P.N. Hobbs (U.K.) as Secretary. Panelists were Mr. S.H. Goldberg (U.S.A.), Mr. B. Kent (U.K.), Mr. M. Otsuka (Japan), Mr. A. Delahaye (Belgium) and Prof. Dr. J.L. Lampreave (Spain).

Seminar A on "*International tax problems of charities and other private institutions with similar tax treatment*" was chaired by Mr. J.D.B. Oliver (U.K.); Panelists were Dr. K. Neuhoff (Federal Republic of Germany), Mr. T. Miyatake (Japan), Mr. A. Feder (U.S.A.) and

Mr. M. Benoit (Canada). Lord Nathan, Chairman of Interphil, assisted the Panel.

Seminar B on "*Interpretation of tax treaties – conflicts caused by reference to internal law*", was chaired by Mr. J.F. Avery Jones (U.K.), who was assisted by Mr. C. van Raad (Netherlands), Sir Ian Sinclair KCMG QC (U.K.), Prof. Dr. Klaus Vogel (Federal Republic of Germany) and Mr. David A. Ward QC (Canada).

Seminar C on "*Tax aspects of new types of finance transactions*" was chaired by Mr. David Bucks (U.K.) and dealt with specific knowledge of the international money market. The Panelists were Messrs. R. Briffett (U.K.), Dr. W. Diehl (Federal Republic of Germany), G. Mangieri (U.S.A.) and T. Miyatake (Japan).

Seminar D on "*Recent changes in U.K. corporation tax – investments from and into the U.K.*" was led by Messrs. I.D. Barnett (U.K.) and Prof. M.A. King (U.K.).

PERMANENT SCIENTIFIC COMMITTEE

The PSC met in February 1986 in Rome at the invitation of the Italian Branch. It was attended for the first time by Mr. H.M.A.L. Hamaekers, the new Chief Executive of the International Bureau of Fiscal Documentation. It reviewed the Congress proceedings, particularly those of the London Congress, and studied means for further improving the scientific aspects of future Congresses. During the London Congress a small questionnaire was distributed and, on analysis, this showed that around 50% of the participants were satisfied with the choice of the main subjects and that an overwhelming majority were pleased with the topics selected for the seminars. However, a slight majority were dissatisfied with the resolution proceedings and a minority were not happy with the simultaneous interpretation. It was recommended that in the future the same procedure for resolutions be followed as during the London Congress, i.e. requesting participants to submit amendments in writing before the beginning of the Friday afternoon discussions. Only amendments reflecting the scope of the earlier discussions will be incorporated in the final resolutions. The Chairman of the Resolutions Committee should be given the discretionary power to add any salient points, which the Friday session should reveal as being essential, under a separate note in his Explanatory Note to the Resolutions. The PSC has also instituted a draft format for IFA resolutions based on the format for resolutions adopted by the General Assembly of the United Nations whose Rules of Procedure for Amendments the IFA now follows.

These and other measures will be instituted at the New York Congress and will be reviewed in Spring 1987. It was also decided to distribute the questionnaire again in New York and it is hoped that there will be an even larger response.

EXECUTIVE COMMITTEE

The Executive Committee met in Spring 1986 in New York at the invitation of the U.S.A. Branch.

Three members had to retire from the Committee in London in view of statutory requirements, namely Dr. K. Beusch (Federal Republic of Germany), Mr. A. Elvinger (Luxembourg) and Dr. A. Toffoli Tavolaro (Brazil). Four new members were appointed by the General Council in London: Mr. A. Buelinckx (Belgium), Mr. G. Delorme (France), Dr. A.R. Lopez (Argentina) and Mr. A. Willemsen (Federal Republic of Germany).

The Executive Committee's May 1986 meeting was presided by IFA's new President, Mr. R.M. Hammer (U.S.A.)

MEMBERSHIP FEES

The General Treasurer stated that IFA's financial position was still healthy even considering the dramatic drop by the U.S. dollar. However, it will not be possible to keep the membership fees, which were established at a time that the dollar was very strong, at the same low level. The Executive Committee, therefore, proposes to increase the membership fees to the following amounts:

- US$ 35 for individual members of National IFA Branches;
- US$ 37 for direct individual members of IFA; and
- US$ 85 for corporate members, both direct and of National Branches.

NATIONAL BRANCHES AND MEMBERSHIP

No new National Branches were recognized at the London Congress. IFA now has 35 Branches all over the world and a membership of approximately 7,000. Mr. A. Elvinger (Luxembourg) once again chaired the Nomination Committee during the Congress. He was assisted by Mr. C.G. Greaves (U.K.), Mr. T. Miyatake (Japan) and Mr. Sainz Alarcon (Mexico).

National Branches of IFA are urgently requested to send notifications of their meetings, seminars and workshops to the General Secretariat in Rotterdam, which will arrange for their publication in the Bulletin for International Fiscal Documentation published by the International Bureau of Fiscal Documentation.

INTERNATIONAL BUREAU OF FISCAL DOCUMENTATION

At the same time that IFA is growing, so is the International Bureau of Fiscal Documentation. The Chief

Executive, Prof. J. van Hoorn Jr., reached statutory retirement age in December 1985. The International Fiscal Association is grateful to Prof. Van Hoorn for his commitment in both organizations. His retirement from the Bureau also entailed his retirement as an ex officio member of IFA's Permanent Scientific Committee and General Council. We welcome his successor in both functions, Mr. H.M.A.L. Hamaekers, and we wish him every success in his endeavors.

The IFA is pleased to have the opportunity to collaborate with the Bureau in conjunction with their respectice anniversaries in 1988. Both will then be 50 years of age, and for this special occasion, the IFA and the Bureau will be cooperating in the production of a special "Resolutions booklet", containing all the resolutions IFA has passed.

IFA looks back on a cooperation with the Bureau which has been mutually beneficial and looks forward to a brighter future together.

NEW YORK CONGRESS 1986

At the time this report was written, the preparations for the New York Congress were finalized. The Opening Ceremony will be held in the Hall of the General Assembly of the United Nations Building, followed by an informal reception.

The officers for the 1986 New York Congress will be:

General Reporters: Mr. Y. Kergall (France) for Subject I, and Mrs. M. Burge and Mr. P. Farber (U.S.A.) for Subject II.

Discussion Leaders are Prof. Dr. A. Rädler (Federal Republic of Germany) for Subject I, and Mr. J.W.B. Westerburgen (Netherlands) for Subject II. Chairmen of the Resolutions Committees are Mr. A. Elvinger (Luxembourg) for Subject I and Mr. B.J. Reynolds (U.K.) for Subject II. The Panels and Resolutions Committees will be assisted by a number of distinguished members.

FUTURE CONGRESSES

1. Brussels Congress 1987

The subjects for the Brussels Congress were determined as follows:

Subject I: *"The fiscal residence of companies"* (General Reporter: Prof. Dr. J.N. Rivier (Switzerland)).

Subject II: *"Tax problems of the liquidation of companies"* (General Reporter: Prof. G. van Fraeyenhoven (Belgium)).

Seminar A: *"Taxes and Human Rights"* (Chairman: Dr. Marc Baltus (Belgium)).

2. Amsterdam Congress 1988 (50th Anniversary of IFA)

The following subjects were selected:

Subject I: *"Characterisation of foreign associations"* (General Reporter: Dr. C. van Raad (Netherlands)).

Subject II: *"Tax treatment of computer software"* (General Reporters: Messrs. R. Mattson and J. Jones (U.S.A.)).

MITCHELL B. CARROLL PRIZE

The Mitchell B. Carroll Prize, presented to persons under 35 years of age who have submitted a paper devoted to international fiscal law, comparative tax law, or national tax law having an important relation with fiscal law in foreign countries, was not awarded in 1986.

BRITISH BRANCH

Annual Meeting

On 12 June 1986 the British Branch of IFA held its Annual General Meeting in London.

The Chairman presented his Report for 1985/86 telling that membership at 31 March 1986 was 488 made up of 357 individual and 131 corporate members. Nine technical meetings had been held in London with attendances of from 30 to over 100, and five meetings with average attendance of 25 had been held by the Manchester sub-branch.

Several years of preparation had culminated in the hosting of the 39th IFA Congress in London in September 1985. Many members of the branch had participated in the organisation and running of both the scientific and social program and the Chairman passed both his and Central IFA's warmest thanks to all concerned.

The accounts were adopted on the proposition of Mr. Barnett, seconded by Mr. Smart. The Treasurer and the Chairman also reported on the IFA 39th International Congress Trust Fund which consists of initial donations in 1974, the excess over expenditure of the 1975 and 1985 Congresses and interest earnings less expenditure on charitable trust purposes. A gift was being made to Central IFA to endow payments to winners of the Mitchell B. Carroll prize and ideas were being studied for further expenditure on research in the field of international taxation.

The Chairman announced that Messrs. Eric Henbrey and John Reynolds had resigned from the Committee though both intended to remain active in the branch. He thanked both for their service to the branch over many years and John Reynolds for his terms as secretary and as a Vice Chairman. Messrs. Bartlett, Chown, Hickman, Hobbs and Swaine retired by rotation. The same five members and Mrs. Jill Pagan and Mr. Michael Smart had been 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 reported that the Committee had appointed Mr. David Oliver to succeed Mr. Reynolds as a Vice Chairman and had appointed Mr. Eric Tomsett to succeed Mr. Hickman who would be handing over as Honorary Secretary during the course of 1986/87. Ms. Claire Beziau would be succeeding Mr. Robert Johnson as Assistant Secretary. Mr. John Avery Jones would succeed Mr. Reynolds as a member of the IFA General Council and Messrs. Oliver and Tomsett would become deputies in place of Messrs. Avery Jones and Henbrey.

A meeting to consider the draft National Reports for the Brussels Congress had been fixed for 25 September.

A full discussion was held on the program and preference emerged for meetings on U.S. and Australian tax developments, on tax and corporate finance, with the Revenue on international tax avoidance, on Exchange of Information, on practical aspects of Double Taxation Relief, and on recent tax cases. The meeting was not enthusiastic about suggestions for talks on EEC developments, tax havens and on the judiciary's new approach to tax law although it was suggested that one later date be kept blank for a then topical subject. It was requested that again a wine tasting and again a dinner at the Barber-Surgeons' Hall be held.

GERMAN BRANCH

Fiscal Harmonization within the EEC

By Dr. jur. Karl-Dieter Wingert

At its annual meeting on 26 April 1986 in Bamberg, the German IFA Branch held a panel discussion on the subject:

Present state and further development of fiscal harmonization within the EEC.

The Chairman, Mr. Beusch, welcomed in particular Mr. Robert Goergen from the EEC Commission, Professor Laule, Frankfurt, Mr. Ritter, BASF/Ludwigshafen, and Dr. Uelner, Federal Ministry of Finance, Bonn.

Mr. Goergen began his statement by pointing out that the EEC Commission gives high priority to the completion of the internal market. This political aim was approved in the European Act of the European Government Conference of 16/17 December 1985. In its White Paper of 1985, the EEC Commission outlined its ideas on the completion of the internal market. In this context, removing fiscal frontiers is regarded as the most difficult task to achieve. In addition to the customs union, fiscal harmonization is considered absolutely essential, despite the problems involved.

The tax base of value added tax (VAT) has, to a large extent, been harmonized. As to excise duties in general, the EEC Commission has so far only reached a basic decision that such duties shall only be levied on tobacco, alcoholic beverages and mineral oil. However, excise duties on tobacco have already been harmonized to a certain extent.

The removal of border controls is an indispensable precondition for the free movement of persons, goods and services within the Community. This in turn requires a satisfactory Community procedure, which grants the same treatment to cross-border transactions as to similar transactions within the individual Member States. As in domestic transactions, VAT must be payable by the seller and be deductible irrespective of the Member State in which it was levied. This would require a clearing system to ensure that the VAT levied by the exporting country and deducted in the importing country is refunded to the latter country.

In the Commission's view, such a VAT-clearing system can only work if:

- the tax base is further harmonized;
- the structure of VAT is largely unified (the individual Member States have up to seven different rates. The objective should be to have a maximum of rates – a standard rate, a reduced rate and a rate for luxury goods); and
- the tax rates are approximated as well (at present VAT rates in the EEC range from 0 to 38%).

As a first step, the programme of the EEC Commission envisages the adoption of a standstill agreement. To this end, a draft directive has already been submitted. It requires the Member States to desist from making any changes in the number and level of existing VAT rates.

In the field of excise taxes, one of the main objectives is to prohibit the introduction of any new taxes.

The Commission intends to submit proposals for the rate structure and level of VAT by the end of 1986. They will provide for the possibility of deviating from the standard rate by ± 2.5%.

The proposals for the harmonization of direct taxes have been on the table for a long time: cross-border mergers, dividends, especially those between parent companies and subsidiaries, rules for profit determination, consideration of loss for tax purposes, and arbitration procedures. The package of three draft directives, put together in 1984, concerning mergers, parent-subsidiary relations and arbitration procedures, has not been adopted as yet, which is mainly due to the failure to reach agreement on the parent-subsidiary directive.

The EEC Commission considers a reduction in corporate taxation extremely urgent. It has created the conditions for the elimination of company tax and in particular supports current efforts to eliminate non-profit-related tax elements.

At the beginning of his contribution, Mr. Uelner pointed out that the unification of Europe is first and foremost a political goal for maintaining Europe as an independent force. Economic union is merely an instrument for achieving this goal; it is not an end in itself. For fiscal harmonization the following aspects, in particular, must be taken into account:

- The individual Member States will remain sovereign for a long time to come. Each of them must finance its own Budget.
- The Budget means can only come from domestic tax receipts. Tax structures in the individual Member States vary greatly.
- Present differences in tax structures have developed over decades or even centuries against the background of differing mentalities in the EEC countries. These differences cannot be eliminated overnight, and there is even less hope of developing a common tax system starting from a theoretical zero point.

Against this background, completing the internal market by 1992 will only be possible by proceeding along the lines set out by the EEC Commission. This will require a fiscal compensation scheme between the Member States in the form of a clearing procedure. Furthermore, it will be necessary in all Member States to provide for controls of the individual taxpayer, e.g. to verify whether tax paid on input is being properly deducted.

Mr. Ritter started by asking why the Federal Republic of Germany did not carry out a sort of discreet harmonization, in view of all those problems involved in bringing tax systems closer together. This could be done by considerably reducing direct taxes, which are very high in the Federal Republic as compared with most other Member States. In its harmonization program, the EEC Commission has taken the wrong approach. Indirect taxes cannot be harmonized without at the same time making adjustments in direct taxes. The Community is not following this – admittedly difficult – path, but rather tends to proceed on the principle of avoiding matters that involve difficult problems. This is clearly illustrated by the fate of the arbitration directive, which originally was to be adopted only in conjunction with the directive on mutual administrative assistance.

A first step in harmonizing taxes must be to approximate their rates. Corporate taxes cannot be harmonized as long as special taxes, such as business taxes or non-profit-related taxes on companies remain in existence.

Harmonization of types of taxes must be followed by harmonization of the system and level of corporate taxes, which in turn is a prerequisite for harmonizing withholding taxes on dividends and interest. For this reason, the Commission proposal for a directive on taxation of distributed profits should be dealt with at a later stage of harmonization.

The issue of harmonizing the tax base must not be tackled until the types, systems and levels of direct taxes have been harmonized. On the other hand, in the case of direct taxes the harmonization of the tax base is problematic, if it is not accompanied by a harmonization of what is happening in practice. If this connection is disregarded, then the harmonization of the tax base may even have a "disharmonizing" effect. It must also be taken into consideration that in the case of direct taxes, the tax base is of much greater importance than in the case of indirect taxes.

In international direct taxation, top priority must be given to the avoidance of double taxation. Here, mention must be made of the directive, still to be adopted, on a European arbitration procedure, which will have to be developed into an efficient and independent arbitration court.

A first concrete step in the field of direct taxation would be to adopt the package of three directives mentioned by Mr. Goergen. This has so far not been possible due to the Federal Government's opposition to the parent-subsidiary directive. However, as the present version of this directive is favorable for German business, Mr. Ritter suggested that the annual meeting draw up a resolution asking the Federal Government to agree to the parent-subsidiary directive.

Professor Laule pointed out that in the further harmonization of tax systems a sort of target will have to be set for the ratio between direct and indirect taxes. In comparing the tax systems, account must be taken of differences in the efficiency of tax collection in the individual Member States.

In tax-consulting activities, the high degree of harmonization of VAT becomes obvious. In addition, there is the possibility of recourse to the European Court of Justice concerning questions of the implementation of the 6th VAT directive.

Further fiscal harmonization in the EEC will have to cope with the enormous discrepancies between direct and indirect taxes on the one hand, and between personal income and corporate taxes on the other. Thus, for instance, in some Member States high top rates of income tax correspond with considerably lower corporate tax rates.

In the ensuing discussion the view was taken that there was a need to harmonize not only tax laws, but also the political objectives to be financed from tax receipts. On the other hand, it was proposed to leave the different tax laws, as quasi local conditions, unharmonized and to leave their harmonization to the market forces. In addition, the discussion touched upon further details of fiscal harmonization, for instance concerning the 14th turnover tax directive. There was wide agreement on Mr. Ritter's proposal to request the Federal Government to agree to the adoption of the parent-subsidiary directive.

BANGLADESH:

Some Highlights of the 1986-87 National Budget

By K.A. Gofran

The Budget of the Government of the People's Republic of Bangladesh for the fiscal year 1986-87, as announced by the Finance Adviser over radio and television on 27 June 1986, envisages revenue receipts of 44,680 million Tk. and an outlay of 37,400 million Tk. on Revenue account, leaving a surplus of 7,280 million Tk. This revenue surplus, together with the yield from some new fiscal measures and the raising of loans from the domestic market, will partially finance the Annual Development Program's 47,640 million Tk. for the year, but it will mainly be financed by Foreign Aid and grants. According to the Finance Adviser, the Budget for the fiscal year is expected to help increase domestic production, give a boost to the agricultural sector, keep the price levels down, support increases in production in the industrial sector, and aid exports. Further, a meaningful program has been formulated in the Budget for the alleviation of poverty.

The Finance Advisor disclosed that the growth rate for the GDP has been projected at 5.2% for the coming year, of which growth in the agricultural sector will be around 3.6%, and that in the industrial sector will be 10.3%. The gas and electricity sector is expected to register a growth of 26% and the transport sector is expected to have a growth rate of 6.2%. It has, however, been stated that in 1985-86 GDP growth stood at 4.9% as against a projection of 5.4%. There was an increase in agricultural products except wheat over the preceding year. Jute production during the year was recorded at 7,600,000 bales as against 5,100,000 bales in 1984-85. Food crops production is expected to increase by 4% over that of last year (1984-85). As a result, the growth rate in this sector will be 5%. An estimate of 16,300,000 tons of food crops are expected to be produced, of which production of rice is 15,100,000 tons and that of wheat is 1,200,000 tons.

According to the Economic Survey accompanying the Budget, cost of living during the year 1985-86 has risen by 8.5% as against 10.56% for last year. Furthermore, there was inflation at a rate of 8.64%. In order to contain this inflation there was a curb on the expansion of bank credit and emphasis was placed on payment of recoverable bank loans. In the first nine months of 1985-86 there was an increase in bank credit by 6.56% and over-all money supply by 6.76%.

THE NEW FISCAL MEASURES: 1986-87

The Finance Adviser spelled out certain fiscal measures in order to generate some domestic resources to augment the revenue receipts of the Government, particularly those relating to imposition of new levies and fees in respect of air passengers. Some rationalisations and adjustments of the existing taxes and duties were also announced. These, in brief, are:

Income tax

Recognising the role of income tax not only for raising revenue, but also for socio-economic balance, the following measures were announced:

(a) To encourage more investment in the passenger transport sector, existing provisions for the rebate of 25% of tax attributable to income from passenger buses and passenger launches have been raised to 50%;
(b) To encourage production and, consequently, the generation of more employment, a system of rebate has been provided for small and cottage industries. If the volume of production in small and cottage industries increases by more than 15% over the preceding year, a rebate of 2½% will be allowed. This facility will be available only in less developed and least developed areas.
(c) To encourage establishment of publicly traded companies and thereby help activate the Stock Exchange, dividends paid from profits derived during a tax holiday period of a publicly traded company are exempt from income tax.
(d) In view of the increase in prices, the value limit for the purpose of a depreciation allowance for motor vehicles not for hire, has been raised from 200,000 Tk. to 250,000 Tk.
(e) The present restrictive provision of deducting the proceeds of savings certificates (cashed on maturity) from the purchase price of a certificate in that year has been abolished to induce more savings.
(f) Consistent with the provision of paying simple interest by the assessees at 15% on delayed payment of income tax, the rate of interest as a result of delayed refund has also been raised to 15%.
(g) For the purpose of calculating capital gains, provision has been made to adopt the value of the assets in question as on the date of inheritance, gift, bequest or will, instead of the existing provision of adoption of the actual cost to the previous owner.

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(h) In view of the increase in the exemption limit for interest from bank deposits, the minimum limit for the furnishing of an annual statement covering payment of interest by banks has been raised from 5,000 Tk. to 15,000 Tk.
(i) In consideration of the belief in various quarters that effective advertisement is vital to ensure turnover for new and comparatively small industries, the rule prescribing the rate of allowances in respect of publicity and advertisement has been kept in abeyance for further examination.
(j) The present time limit for submitting application for a tax holiday is 120 days. This has been extended to 180 days for the benefit of assessees.
(k) The rate schedule for the current assessment year has been made applicable for computing tax in respect of income from salaries and interest on securities. This will help simplify calculating the tax on income from these sources.
(l) In consideration of the fact that rent for a dwelling has substantially increased in big cities and smaller towns, the existing allowance for repair costs of the houses has been reduced from one-fifth to one-sixth.
(m) In order to induce the taxpayers to avail themselves of the opportunity of low tax rates for individuals and others introduced last year it has been decided that individual assessees declaring income under the head "income from other sources" for the year 1986-87 would be accepted without any questions, but the facility will be available only to those individual assessees who declare at least 250,000 Tk. from said source and pay tax at the time of filing the return. However, assessees upon whom notice has been served concerning investigations for tax evasion will not qualify for the benefit.
(n) The Government has decided to strengthen the tax administration and make it more effective. With a view to this, the post of Senior Commissioner of Taxes (Survey, Search and Seizure) has been created. This person will conduct surveys and supervise searches and seizures of documents and other evidence of tax evasion.
(o) The Self-Assessment Scheme will continue with the condition that new assessees in business or the professions will have a ceiling (for induction of initial capital without any questions) of 150,000 Tk. as against 500,000 Tk. previously.

Additional fiscal incentives for industries set up in an Export Processing Zone

(A) Income tax

The following additional facilities are being extended to industries set up in the Export Processing Zones:

(i) new "high tech" industries will be allowed a tax holiday of 10 years;
(ii) exemption will be allowed for up to 50% of the tax attributable to export sales after expiration of the tax holiday period of 5 or 10 years, as the case may be;
(iii) dividend income of non-resident shareholders will be exempt from tax during the tax holiday period. This exemption will also be available after the tax holiday period if the dividend income is reinvested in the same project; and
(iv) accelerated depreciation to the extent of 100% of the actual cost of machinery or plant will be allowed to a high tech electronic industry during the tax holiday period.

(B) Excise duty

The Excises and Salt Act, 1944 has been amended, exempting manufacturers in the Export Processing Zones from excise control and payment of excise duty.

(C) Stamp duty

Land allotted in the Export Processing Zones has been exempted from stamp duty.

Wealth tax

The aggregate of income tax and wealth tax was fixed at a maximum of 60% of total income in 1981, as the highest slab rate of income tax was 60% at that time. The highest rate of income tax was reduced to 50% last year. Accordingly, it has been decided to reduce the aggregate of income tax and wealth tax from 60% to 50% of the total income.

Additional tax on the transfer of immovable property

The immovable properties transfer tax is now being raised from 1% to 2%. The Government may, by notification in the Official Gazette, exempt any person or persons from the payment of additional tax.

Foreign travel tax

At present Bangladeshi nationals must, for travel abroad, pay 50 Tk. for each journey by land and 200 Tk. for each journey by sea. Compared to the tax rate for travel abroad by air, these rates are quite low. In order to rationalise these rates, taxes for foreign travel by land and by sea have been refixed at 100 Tk. and 400 Tk. respectively for each trip.

Air ticket tax

A tax is imposed on flight tickets in many countries to raise Government revenue. It is now proposed to impose a tax of 30 Tk. on each domestic flight ticket and 100 Tk. for each international flight. This tax on flight tickets will be effective from 1 August 1986.

Turnover tax

A turnover tax at the rate of 2% of the commission earned is being levied on indenting firms.

Rate of income tax

The rates and schedules of income tax applicable for the fiscal year 1986-87 are shown in the Appendix.

APPENDIX

THE SECOND SCHEDULE
(see section 13)

RATES OF INCOME TAX

A. In the case of every individual, Hindu undivided family, unregistered firm, an association of persons and every artificial juridical person referred to in 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 50,000 taka of taxable income	10%
(2) On the next 50,000 taka of taxable income	20%
(3) On the next 50,000 taka of taxable income	30%
(4) On the next 50,000 taka 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 14, 17, 18 and 20 of Part B of the Sixth Schedule to the Income Tax Ordinance, 1984 (XXXVI of 1984) does not exceed 30,000 taka; and

(ii) the income tax payable shall in no case exceed:
   (a) one-third of the amount by which the total income exceeds 30,000 taka, or
   (b) the amount representing 50% of the total income, whichever amount is the lesser:
   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 intome, 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 provision 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 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 a rebate at the rate of 10% of the tax shall be allowed to a company registered in Bangladesh under the Companies Act, 1913 (VII of 1913), on so much of its income, profits and gains accruing or arising outside Bangladesh to which section 13(4) of this Ordinance does not apply as are brought by it into Bangladesh:

Provided further that the person owning a small and cottage industry located in the Less Developed Areas and the Least Developed Areas and a company registered in Bangladesh under the Companies Act, 1913 (VII of 1913), and engaged in the production of goods shall be allowed rebate on income tax payable by him or 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 of the preceding year	5% of the income tax attributable to such income.
(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:

(a) in the manufacture or processing of goods;
(b) in the manufacture of plants, machinery, tools and implements or accessories of all descriptions;
(c) in the construction of vessels, or in the manufacture of vehicles;
(d) in the exploration and extraction of gas, oil or any other minerals; and

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 ⅔rds 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 2,000,000 Tk.;
(c) at least 50% of the paid-up capital of the company as at the end of the accounting year is subscribed by the shareholders other than the directors and sponsors of the company;
(d) no share of the company has been purchased in benami[1] by the directors and sponsors of the company;

1. Benami is "name lending".

(e) average ownership of shares of the company is at least 1 for each 20,000 Tk. of the paid-up capital;
(f) a dividend of at least 10% has been declared 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.

Explanation (3)

The term "Less Developed Areas" and "Least Developed Areas" shall be the areas as specified in the National Board of Revenue Notifications No. S.R.O. 411-L/85, dated 22 September 1985, and No. S.R.O. 412-L/85 dated 22 September 1985, respectively.

C. In the case of every registered firm, the income tax shall be charged at the following rates:

	Rate
(1) On the first 30,000 taka of total income	Nil
(2) On the next 30,000 taka of total income	10%
(3) On the next 70,000 taka of total income	15%
(4) On the next 70,000 taka of total income	20%
(5) On the balance of total income	25%

Provided that income tax shall not be payable by a registered firm in respect of the income, profits and gains derived by it from the exercise of a profession if such income, profits and gains depend wholly or mainly on the personal qualifications of its partners who are prevented by any law for the time being in force or by convention or rules or regulations of the professional association, society or similar body of which they are members to constitute themselves into a corporate body with a limited liability which can be registered as a company under the Companies Act, 1913 (VII of 1913), unless such profession consists wholly or mainly in the making of contracts on behalf of other persons or the giving to other persons of advice of a commercial nature in connection with the making of contracts.

Explanation: The term "registered firm", as used in this paragraph, means a firm registered under section 111 of the Income Tax Ordinance, 1984 (XXXVI of 1984).

ZAMBIA:

The 1986 Budget

By A.B.C. Emmanuel

The 1986 Budget has been called by many the "Relief Budget." There was a sigh of relief from the middle income groups, especially the fixed income earners, because of the tax reliefs granted. Even the top income bracket earners were given relief when the highest rate of tax was decreased from 80% to 65%. This relief had to come and was awaited by all because of the high cost of living and unemployment caused by the drop in the kwacha in the wake of the foreign exchange auction that was brought into operation in October 1985.

The problems experienced by Zambia in 1984 continued in 1985. These included:
(a) sluggish production in many sectors of the economy due to shortages of inputs;
(b) significant pressures on prices leading to a fall in real income;
(c) balance of payment problems; and
(d) high rate of unemployment.

Copper, which is still the foremost earner of foreign exchange, saw a slight increase in its price in the early part of the year to £1104 per ton, greatly due to the lower value of the pound. Later the price fell to a very low figure of £960 per ton.

The average price of lead and zinc were 699 K and 1318 K per ton respectively compared to 805 K and 1610 K in 1984. However, the price of cobalt rose from 36,130 K per ton in 1984 to 57,406 K in 1983.

Copper exports continued to decline from 540,450 tons in 1984 to 470,500 tons in 1985. In 1980, 681,000 tons were exported. This represents a decline of 30.9% since 1980.

The total export earnings fell from US$ 895 million to US$ 830 million in 1985, reflecting a fall of 13% in the volume of copper. Imports went up from 1,108 million K in 1984 to 1,761 million K in 1985. After the introduction of the foreign exchange auction system, imports began to increase in real terms with the regular injection of foreign exchange through this system.[1] The relaxation of restrictions on imports involving no initial allocation of foreign exchange also proved helpful in this direction.

The mining sector, on which the country depends for its revenue and foreign exchange, continued to report a decline in production despite the actions taken in 1984 to rehabilitate the industry. Copper production fell from 522,000 tons in 1984 to 478,000 tons in 1985. This has a serious effect on the country's foreign exchange earnings.

To arrest this decline the Government has embarked on a major programme of rehabilitation with the aid of US$ 75 million from the World Bank; Unit of Account 26 million from the African Development Bank; and 55 million ECU from the European Economic Community. The mining sector is expected to

1. On 4 October 1985, the President announced that "with effect from today, the Zambian kwacha will be delinked from the special basket of currencies which has determined the exchange value vis-à-vis foreign currencies from that time." Instead, the auction system was to determine the exchange rate freely in the market place, except for certain items, to allocate foreign exchange to importers. The exchange auction is held weekly and the rate varies from auction to auction depending on the demand for and the supply of foreign exchange at each auction.

maximise production and while keeping the cost of production as low as possible.

The agricultural sector, due to good weather conditions, reported better results. Maize production went up from 6.2 million bags to 7.2 million bags in 1985. Other crops such as soya beans, millet, sorgham, groundnuts and rice also showed increases. However, tobacco, sunflower and cotton seed showed a slight decrease.

The manufacturing sector did not show an increase due to the heavy dependence on imported materials which could not be satisfied due to the severe shortage of foreign exchange.

Under the new auction system for determining the exchange rate of the kwacha and allocating foreign exchange, the manufacturing sector has suffered greatly as far as imported materials are concerned. However, this has supported the use of local resources as much as possible because of their relative cheapness. The auction system has given the manufacturers an opportunity to obtain foreign exchange regularly and thus encouraged production. In the last quarter of 1985, the manufacturing sector received US$ 28.7 million through the auction system.

It can be seen from the above facts that the main problem affecting Zambia's economy is the severe shortage of foreign exchange which has badly affected the performance in all sections, especially those sectors that depended heavily on imported materials. The second problem is the lack of adequate production in the economy, and the third is the persistance of serious imbalances in Government finances. Unless enough foreign exchange is earned, the economy will not pick up.

Ever since the fall in the price of copper, which brings in 95% of the country's foreign exchange earnings, and the huge rise in the price of oil, Zambia's foreign exchange position has gone from bad to worse. Severe measures had to be taken to improve the economy which is said to be very sick. Zambia was not able to meet all her obligations in respect of imports and services from other countries. Payment arrears had accumulated to about US$ 500 million. Because of this, Zambia's credit worthiness had been eroded and all the export guarantee facilities which she used to enjoy are no longer available.

While there has been a drop in export earnings, foreign exchange earnings, etc., on the other hand, there has been a growth in the population at the rate of 3%. This added to the unemployment problems and the Gross Domestic Product per capita fell from US$ 404.1 in 1983 to US$ 319.8 in 1984.

In the face of these conditions, something had to be done. It was a well-known fact that the kwacha was over-valued. It had to find its true level. The auction system was thought to be the answer. "It is one of the bravest economic gambles that any African country has taken" said *The Economist.*

From October 1985, the Zambian kwacha was delinked from the special basket of currencies which had determined the exchange value vis-à-vis the foreign currencies. From that time the auction system was to determine the exchange rate freely in the market place, except for certain items to relocate foreign exchange to importers. The auction was to be held weekly and the rate was to vary from auction to auction depending on the demand for and the supply of foreign exchange at each auction.

The objective of this system was to improve the economy, find the valuable scarce foreign exchange and establish the true value of the kwacha. It was a well-known fact that a black market in foreign exchange was thriving and this auction system was believed to be able to stop this and siphon off some of the excess kwachas in circulation. It was also thought that, due to the availability of foreign exchange, more jobs would be available, resulting in better incomes, more opportunities and better living standards.

The first auction put US$ 5 million on the block. The kwacha fell from 2.3 kwacha per dollar to 5 K per dollar. Within days the price of petrol and petroleum products rose by 100%. The Government had scrapped the subsidies on various food items resulting in huge price increases in mealie meal (the staple food), cooking oil and other essential items. Many industries could not afford to buy foreign exchange resulting in lay-offs and an increase in unemployment.

However, there were signs of the economy improving very slowly. A number of investors were making inquiries about investment opportunities in Zambia. There was also evidence of some prices beginning to decline because the business sector was now able to import their requirements without going through a middleman. With imports being able to be paid promptly, the charges that were included in the prices were now discontinued and the volume of revenue from customs, etc., was increasing. In December 1985 the amount of revenue collected from customs duties and sales taxes on imports reached 20.7 million K – compared to an average of 11.5 million K during the preceeding 11 months.

The basic strategy for 1986 was to "build on the foundation already laid". In particular, the Government policy was aimed at:

(a) promoting the growth of non-mineral exports as quickly as possible;
(b) mobilising additional resources from outside;
(c) promoting domestic production;
(d) containing the pressures on prices;
(e) stabilising the exchange rate; and
(f) lowering interest rates.

As mentioned above, due to the introduction of the auction system and its effects on the prices in the country, the Minister of Finance had a very difficult task in introducing tax measures in the Budget. The Government could not give substantial wage raises to employees because it could not afford to do so, nor could the parastatals and private sector. Wage increases could also lead to price increases. Therefore, the Government decided to grant relief in the form of tax reductions and tax exemptions.

TAX MEASURES

1. In order to alleviate the burden on fixed income earners, especially pensioners, the Government declared that income received by these taxpayers not exceeding 2,400 K per year would be exempted from tax.

2. To help those employees who had been compulsorily retired and to assist them to settle down on the land and find other sources of livelihood; the benefits paid by way of ex-gratia payments, compensation for loss of office or employment, and terminal benefits were to be tax-free on the first 10,000 K.

3. To encourage employees to build houses and relieve the employer of the responsibility of finding accommodations, which are in very short supply, it was decided to treat as tax-free the housing allowance paid by the employer to owner-occupier employees. This is restricted to the first 10,000 K or 50% of the taxable emoluments, whichever is less. Since mortgage interest paid is also free of tax, the employee has the option to choose between the amount of housing allowance or the mortgage interest.

4. In view of the high cost of maintaining motor vehicles it was also decided that allowances up to a maximum of 12,000 K per annum, granted in place of a car, will not be taxable. This is a major relief because the previous tax-free allowance was only 720 K per annum.

5. Terminal benefits payable to a public officer (civil servants) at retirement will be tax-free up to a maximum of 10,000 K.

6. *Child allowance.* The tax-free allowance in respect of each child has been increased from 325 K per annum to 330 K per annum. But, to appease the agitation by some married women who complain that it is unfair to grant this relief to the husbands, it has been decided to divide this allowance between husband and wife. Where the man or the woman alone is working, he or she will claim the allowance.

7. *Inducement allowance.* Expatriates recruited for employment in Zambia had been granted exchange control permission to remit 1/3 of their monthly emoluments, subject to a maximum of 833.33 K per month. Since the auction system began there has been an increase in prices and at the same time a sharp drop in the value of the kwacha. In order to remit the same amount of income as previously, the employee must now obtain a large amount of kwacha. The rate which was 2.30 K per U.S. dollar on 30 September 1985 is today over 7 K per U.S. dollar. This reduces the remittance greatly. In fairness to such employees it has been decided that new contracts be drawn up from 1 January 1986 on a two tier basis: (a) An inducement allowance designated in U.S. dollars which will be remittable on a monthly basis and an end of contract gratuity also designated in U.S. dollars calculated at 25% of the inducement allowance earned during the contract. The maximum inducement allowance will be US$ 550 per month. These will be tax-free. (b) A local salary which will be taxable.

8. *Personal tax.* As seen from the above paragraph, there are two types of employees: those who receive inducement allowances and those who do not. Since the inducement allowance is tax-free there will be a loss in revenue. In order to recoup part of this loss it was decided to have two tax schedules, i.e. higher rates for those who receive inducement allowances and lower rates for those who do not. This will also satisfy the employees who do not receive the allowance because the lower rate will reduce their tax by almost 18% of the amount of tax presently payable.

   The schedules are as follows:

Those who remit		Those who do not remit	
Taxable income	*Rate*	*Taxable income*	*Rate*
First 2,000 K	10%	First 2,000 K	5%
next 3,500 K	25%	next 3,500 K	15%
next 4,500 K	40%	next 4,500 K	25%
next 5,500 K	55%	next 5,500 K	35%
next 6,500 K	65%	next 6,500 K	45%
next 8,000 K	70%	next 8,000 K	55%
		next 10,000 K	60%
Excess	75%	Excess	65%

   Although the inducement allowance is tax-free in the hands of the employees, that amount that is payable by the employer is not allowed as a deduction from his income for tax purposes. This is one way of discouraging the employment of expatriates and retaining only those who are essential and cannot be replaced by locally qualified persons.

9. *Company tax.* There has been a change in tax policy in relation to taxing company profits. To encourage manufacturers and producers the company rate of tax has been reduced from 50% to 35%. Those who are producers of services have their tax rate reduced from 50% to 45%. This is a way of allowing more liquidity and profits to manufacturers to enable them to reinvest the additional resources in further production, expansion and job creation.

10. *Capital allowances on motor vehicles.* The prices of motor vehicles have increased tremendously, but the amount allowed for capital allowances is only 9000 K. It has been decided to increase this amount to 25,000 K per annum.

11. *Property transfer tax.* A property transfer tax was introduced in 1984, fixing the rate at 2.5% of the value of the property involved. This is now increased to 5%.

12. *Education levy.* The rate was 200 K for each company incorporated in Zambia. This is now increased to 1,000 K per annum. However, where a company has a turnover of not more than 20,000 K per annum the levy will be only 500 K.

13. *Companies Act: prescribed fees.* The fees charged under the Companies Act have been unchanged since 1965. To keep in line with the high cost of services and the wide range of services provided by the Government it has been decided to raise the fees as follows:

    (i) Registration of Company
    The fee is raised from 0.25 K to 5.00 K for every 200 K; but the minimum fee for registration will be 100 K instead of 10 K.
    (ii) Increase in Share Capital
    The fee is to go up from 0.25 K to 5.00 K for every 200 K or portion thereof.
    (iii) For a Certificate of Incorporation
    Increased from 0.50 K to 20.00 K.
    (iv) Registration of an altered Memorandum of Association
    Increased from 1.00 K to 20.00 K.
    (v) For registration of Change of Name
    Increased from 1.00 K to 100.00 K.
    (vi) For change of Company Name and publication of same
    Increased from 1.50 K to 150.00 K.
    (vii) For Registration of a Document, etc.
    Increased from 0.50 K to 20.00 K.
    (viii) For inspection of registers
    Increased from 0.10 K to 5.00 K.

14. *Customs duty.* The only changes were those relating to penalties for late payment, the minimum rate of duty and the duty on motor vehicles.
    (a) The penalty for late payment has been increased from 5% of the tax due to 10%.
    (b) The minimum rate has been increased from 10% to 15%.
    (c) The existing rates on duty for passenger cars has been changed to a new formula to lower the duty with a view toward reducing the price of cars imported to Zambia.

15. *Excise tax.* So far the duties have been levied on the basis of specific rates. In circumstances of inflation this has the effect of depressing revenue by making it less responsive to price level. To rectify this it has been decided that excise duties be converted to an ad valorem base in order to increase tax elasticity. The only exception will be the tax on petroleum products which will remain as at present. With this as the basis the duties on portable spirits, clear beer, sugar, soft drinks, etc., have been changed. The prices of petroleum products have also been increased. All these measures hope to increase the revenue by 35.3 million K.

16. *Sales tax.* There is only one change. The tax on telecommunication and related services is now 10% – this is being increased to 15. The increase in revenue is expected to be about 6.0 million K.

As mentioned earlier, the biggest problem facing the country is the serious lack of foreign exchange. The drop in the price of copper and also the drop in production has seriously affected the economy because the mines produce nearly 95% of the foreign exchange. It is therefore necessary to turn to other sources than mineral exports.

To encourage exports, an Export Development Board has been set up. The main function of the Board will be to advise exporters on the markets available for their products and any other issues relevant to the business of exporting.

Secondly, action has been taken to streamline the system of drawbacks which allow exporters to claim back the duty paid on imported materials used in the production of export items.

Thirdly, the Government will encourage the exports of non-traditional exports. Encouragement will also be given to tourism as a means of earning foreign exchange. There are plans to extend the capacity in two of the biggest hotels at a cost of about 175 million K. Other tourist lodges, private hotels and motels are also being improved and expanded. The favourable exchange rate under the auction system should be attractive to tourists.

Although great hardships have been caused by the auction system there are signs that the economy of the country will pick up. There have been generous loans granted by countries who feel that Zambia has taken the correct measures on the road to recovery. The hardships that have been caused by the auction system have been compared by Dr Kaunda "to a patient's reaction when given medicine which makes him uncomfortable before recovering." But recovery is assured and the discomfort, it is hoped, will only last a short time. "We have to export or we perish" said Dr Kaunda and it is the hope of everyone that we export and survive. The accent in 1986 will therefore be on expanding exports.

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- Loonbelasting 1964
  releases 104, 105
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- Belastingheffing bij invoer
  releases 351, 352
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  I, releases 318, 319

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Seminar Services International: Doing Business between the EEC and Comecon Countries. Vienna, 20-21 October (English).

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CUMULATIVE INDEX 1986 – Nos. 1-9

I. ARTICLES:

II. REPORTS AND DOCUMENTS

III. IFA NEWS

IV. CONFERENCE DIARY 22,60,137,228,267,339,420

V. BIBLIOGRAPHY 36,87,138,224,275,365,421

Contents

of the November 1986 issue

SOMMAIRE

INHALTSVERZEICHNIS

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Mr. Lanthier has lectured on taxation at McGill University and Concordia University, Montreal, is a contributor to the Prentice-Hall Tax Service "Income Taxation in Canada", and has authored taxation articles in various journals, including the *Bulletin for International Fiscal Documentation*, *The Canadian Tax Journal*, *The Canadian CA Magazine*, and *The Tax Executive*.

Contents

CANADA:

Draft Guidelines on International Transfer Pricing

By Allan R. Lanthier

I. INTRODUCTION

In March 1986, Revenue Canada issued a draft information circular entitled "International Transfer Pricing and Other International Transactions" (referred to in this paper as the "Draft Circular" or the "Circular"). The Draft Circular describes Revenue Canada's administrative approach to the treatment of international transfer pricing of goods and services in transactions between related parties. In preparing the Circular, the authorities placed considerable reliance on the 1979 report of the OECD Committee on Fiscal Affairs on "Transfer Pricing and Multinational Enterprises" (herein referred to as the "1979 OECD report").[1]

Earlier drafts had been distributed, commencing in 1983, to certain industry groups and interested taxpayers,[2] and were also reviewed by a committee of the Tax Advisory Council on Tax Administration.[3] The Draft Circular reflects various comments and criticisms received in respect of those earlier drafts. While Revenue Canada had indicated that the Circular would be finalized and issued by June 1986, this process has apparently been delayed as a result of additional representations from taxpayers. It appears likely that, if and when the Circular is issued in final form, any further changes will not be of a substantive nature.

Information circulars and interpretation bulletins which are issued by Revenue Canada reflect its views and interpretations, and do not have the force of law.[4] As commented on below, certain of the positions outlined in the Circular may lack clear legal support, and certain taxpayers may ultimately wish to challenge these positions, either with the assessing branch of Revenue Canada or in the courts.

After a brief discussion of the general Canadian climate in respect of international transfer pricing transactions and of the statutory framework, this paper reviews and comments on the positions taken by Revenue Canada in the Draft Circular.

1. It is understood that Revenue Canada also made considerable reference to intercompany regulations issued under section 482 of the United States Internal Revenue Code in formulating its position. However, a specific reference to those regulations which had been included in an earlier draft has since been deleted.
2. The reader should refer to "Canada: Transfer Pricing Issues", N. Boidman, 38 *Bulletin for International Fiscal Documentation* 8/9, 1985 for an excellent analysis of an earlier draft and of related developments in certain other jurisdictions.
3. The Tax Advisory Council on Tax Administration was formed by the federal Minister of National Revenue during 1985 in response to public criticism of certain of Revenue Canada's assessing and collection practices. The Council is composed of tax practitioners and individual taxpayers and its mandate is to advise Revenue Canada on matters related to the administration of the Income Tax Act.
4. There is a trend, however, for the Canadian courts to refer to such documents as external aids, as in Nowegijick v. The Queen (83 DTC 5041), a decision of the Supreme Court of Canada.

II. THE CANADIAN CLIMATE

The subject of transfer pricing is of course receiving increasing attention around the world, and Canada has not been immune to this trend. In the late 1970s, Revenue Canada recognized the need to formalize and improve its review and verification procedures related to international transfer pricing transactions, and a group was established in its specialized audit division with this mandate. Internal guidelines were developed with respect to the audit of transfer pricing issues, and training sessions for Revenue Canada personnel were held across the country. Industry-related pricing guidelines were developed for certain industries (e.g. oil and pharmaceuticals) in conjunction with the United States Internal Revenue Service. Other measures adopted by Revenue Canada included the simultaneous examination program, whereby audits of multinational enterprises are conducted by Revenue Canada in conjunction with foreign tax administrations, and the use of specialists on a consulting basis for audits of certain industries that are particularly complex.[5]

Notwithstanding the above, Revenue Canada has continued to encounter difficulties in many situations involving international pricing. The statutory provisions in the Canadian Income Tax Act[6] are brief and provide little guidance; nor has the limited Canadian jurisprudence in the international pricing area been of much assistance. In addition, the great variety of trading patterns and commercial practices has hampered the search for reliable third party data. Finally, Revenue Canada has often encountered difficulties in obtaining information from foreign parent companies or affiliates of Canadian taxpayers. Revenue Canada's frustrations are illustrated by the somewhat plaintive statement in the final paragraph of the 1983 draft circular (since deleted) that:

> This Circular will of course be amended or withdrawn in the event that its relevance is reduced by either amendment of the pertinent legislation or significant jurisprudence under the current law.

While Revenue Canada may be encountering certain difficulties in respect of international pricing, its resolve remains firm, and multinational enterprises should recognize that the Canadian authorities are increasingly taking an aggressive assessing stance in this area.

III. THE STATUTORY FRAMEWORK

The statutory provisions in the Act are relatively brief and straightforward. Subsection 69(1) of the Act applies where a taxpayer has acquired or disposed of "anything" in a non-arm's length transaction at an amount which differs from fair market value. However, subsections 69(2) and (3) apply more specifically to payments between a Canadian taxpayer and a non-resident with whom the taxpayer was not dealing at arm's length, in transactions involving product prices, rentals, royalties, transportation charges and fees for other services.

Subsection 69(2) provides in general terms that, where the amount that a Canadian taxpayer has paid or agreed to pay to a related non-resident exceeds the amount that would have been "reasonable in the circumstances if the non-resident person and the taxpayer had been dealing at arm's length", the reasonable amount shall, for the purpose of computing the Canadian taxpayer's income, be deemed to have been the amount that was paid or payable therefor. The companion provision in subsection 69(3) provides for a similar adjustment to the computation of the Canadian taxpayer's income where the amount it has received from a related non-resident is less than the reasonable amount.[7]

As noted above, the more general provisions of subsection 69(1) utilize a fair market value test, as opposed to the reasonable arm's length test set out in subsections 69(2) and (3). It would seem that, under the general principle of interpretation that, in the event of any inconsistency, the more specific provision should prevail, the test which should be relevant in most international pricing situations is the reasonable arm's length test rather than fair market value. Revenue Canada appears to now accept the predominance of subsections 69(2) and (3), and, accordingly, the reasonable arm's length test (paragraph 4 of Draft Circular).[8]

Other provisions of the Act which may be applicable in particular situations include section 67 and subsection 245(1) (which deny deductions for an expense except to the extent that the expense was reasonable in the circumstances, or if the expense would unduly or artificially reduce income), subsections 15(1), 56(2)

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5. These initiatives by Revenue Canada have been summarized in "A Revenue Canada Perspective on International Taxation: Transfer Pricing and Related Issues", a paper presented by John R. Robertson to the 1982 Annual Conference of the Canadian Tax Foundation.
6. S.C. 1970-71-72, c. 63, as amended, herein referred to as "the Act".
7. Subsections 69(2) and (3) of the Act are as follows:
   (2) Where a taxpayer has paid or agreed to pay to a non-resident person with whom he was not dealing at arm's length as price, rental, royalty or other payment for or for the use or reproduction of any property, or as consideration for the carriage of goods or passengers or for any other services, an amount greater than the amount (in this subsection referred to as "the reasonable amount") that would have been reasonable in the circumstances if the non-resident person and the taxpayer had been dealing at arm's length, the reasonable amount shall, for the purpose of computing the taxpayer's income under this Part, be deemed to have been the amount that was paid or payable therefor.
   (3) Where a non-resident person has neither paid nor agreed to pay to a taxpayer with whom he was not dealing at arm's length as price, rental, royalty or other payment for or for the use or reproduction of any property, or as consideration for the carriage of goods or passengers or for other services, the amount that would have been reasonable in the circumstances if the non-resident person and the taxpayer had been dealing at arm's length, that amount shall, for the purpose of computing the taxpayer's income under this Part, be deemed to have been received or receivable by the taxpayer therefor.
8. This represents a reversal from the initial draft circular issued in 1983 which stated that, in the Department's view, transfer prices for imported goods were subject to both subsections 69(1) and 69(2), and exports to both subsections 69(1) and 69(3).

and 245(2) (direct and indirect benefits conferred on shareholders or other parties), and Part XIII (tax on income from Canada of non-resident persons).

IV. GENERAL PRICING CONSIDERATIONS

What is a reasonable arm's length price?

The Draft Circular notes in paragraph 7 that the "arm's length principle" in the context of transactions between related parties means that each such transaction should be carried out under terms and at a price that one could reasonably have expected in similar circumstances (similar product or service, market, credit terms, reliability of supply and other pertinent circumstances) had the parties been dealing at arm's length and that, in applying this principle, Revenue Canada endorses and follows the same basic methods as those set out in the 1979 OECD report.

The question remains, however, as to what in fact constitutes a "reasonable" amount for purposes of subsections 69(2) and (3) of the Act, and whether there is any difference between this test and the concept of fair market value. There appears to be no reported Canadian case on point, and in practice it is often considered that there is little if any difference between the two terms. For instance, in the 1986 decision of the Federal Court – Trial Division in *Indalex Limited v. The Queen*,[9] Madame Justice Reed noted that:

> Whether an "expense reasonable in the circumstances" for the purposes of section 67 and subsection 69(2) requires the same test as "fair market value" in subsection 69(1)(a) has not been raised. They have been treated by counsel as raising identical considerations.

Notwithstanding the above, it is evident that there will be situations where the same result will not be obtained under the two tests. The term "fair market value" has generally been accepted as being the highest price obtainable in an open and unrestricted market, between informed, prudent parties dealing at arm's length and under no compulsion to act.[10] Consider this concept of fair market value, for example, in the context of a Canadian taxpayer which decides to expand its trading operations in the Far East and establishes an offshore subsidiary for this purpose. To assist the subsidiary in establishing its markets, the Canadian taxpayer establishes a transfer price more favorable than that which it charges to unrelated parties in more established markets. It is arguable that, in this particular situation, the concept of fair market value (highest obtainable price) would not be appropriate and that a reasonable arm's length price would be below fair market value.

The Draft Circular acknowledges that there may be circumstances where the two tests differ. Paragraph 5 of the Circular provides as follows:

> The term "reasonable arm's length price" in this Circular means the amount, as described in the legislation, that would have been reasonable in the circumstances if the parties to the transaction had been dealing at arm's length and may mean fair market value or another amount depending on the circumstances in a particular case. The presumption is that a reasonable arm's length price would be fair market value but, for example, if a particular supplier were attempting to increase his share of a market, he might temporarily establish an arm's length price that was below the current fair market value. Normally the most persuasive evidence of fair market value or reasonable arm's length price is from the market to which the transfer is being made, as opposed to the home market of the supplier (especially in the case of the transfer of goods).

The principle of separate transactions

The Draft Circular notes that the Act applies to each transaction between related parties and accordingly, in analyzing intercompany transactions, that Revenue Canada will apply the reasonable arm's length test on a transaction-by-transaction basis (paragraph 53). This "principle of separate transactions" has two aspects, both of which evoked considerable criticism in respect of earlier drafts.

The first aspect of the transaction-by-transaction approach is that taxpayers are expected to justify intercompany prices based on specific transactions, and not on a general allocation of group profits in proportion to some type of pre-determined criteria such as respective costs or turnover. Some would argue that, where an intra-group pricing policy results in the Canadian taxpayer earning an acceptable proportion of group income, the transfer prices for specific products or services should by definition be viewed as satisfying the reasonable arm's length test. Whether the Canadian courts would ultimately agree with such a proposition is uncertain. It should be noted that the 1979 OECD report does not endorse these types of "global" methods.[11] Conceptual issues aside, the practical difficulty in finding reliable third party data, and the consequential requirement in such circumstances to revert to "other methods" (discussed below) for determining a reasonable arm's length price, means that relative profitability will, as a matter of practice, remain an important consideration in many international pricing transactions in Canada.

A second aspect of the principle of separate transactions is that, to the extent possible, taxpayers are encouraged to design their intercompany pricing such that (for example) a product is transferred at a reasonable arm's length price for the product itself and, if there are also services being provided, these are identified as a separate transfer and are subject to a separate evaluation and intercompany charge. This "clean price" approach is set out in paragraph 8 of the Draft Circular. If the foregoing is not practical, then the Circular notes that the taxpayer should be prepared to provide, in a comprehensive statement of intercom-

9. 86 DTC 6039, discussed below under "The Indalex Decision".
10. See for example the decision of the Supreme Court of British Columbia in Minister of Finance v. Mann Estate, (1972) 5 WWR 23, affirmed (1974) CTC 222(S.C.C.).
11. Paragraph 14 of 1979 OECD report.

pany pricing policy, the basis on which transfer prices are established worldwide, including a thorough functional analysis of the activities and contributions of each group member, which should refer to factors such as technical assistance, access to technology, reward for economic risk and financing assistance (paragraph 9 of Circular).

While Revenue Canada has been criticized in respect of the "clean price" provisions of the Circular, certain comments should be made in its defense. First, the Circular encourages, but does not insist on, the clean price approach. Second, the position set out in the Circular generally accords with that included in the 1979 OECD report.[12] Finally, a somewhat ominous threat in the 1983 draft circular to the effect that other approaches might lead to double taxation in Canada has now been deleted.[13]

Certain planning points arise when considering the use of a comprehensive versus clean price approach (notwithstanding Revenue Canada's expressed preference for the latter). First, most royalties and service charges paid by a Canadian taxpayer to a non-resident will, as discussed further below, result in the application of Canadian tax to the non-resident under Part XIII of the Act, whereas the same non-resident will normally be exempt from Canadian taxation in respect of any profit on the sale of product to the Canadian taxpayer.[14] It may accordingly be possible to reduce the Canadian tax burden to the non-resident in certain circumstances by implementing a comprehensive approach wherein any royalty or service charges would be eliminated.

A second planning point is more in the nature of a pitfall to be avoided. For example, consider a situation where a Canadian taxpayer imports a product from a related non-resident at a price which is arguably above that which a non-related purchaser would pay, but at the same time pays a favorable royalty rate to the related party. While one might argue that the transfer price for the product is a reasonable arm's length price having regard to all the circumstances and particularly to the favorable royalty rate, the danger is that subsection 69(2) might apply to adjust the product price to the Canadian taxpayer without a corresponding adjustment in respect of the favorable royalty rate. Notwithstanding the deletions of paragraphs 66 and 67 originally included in the 1983 draft,[15] it would therefore be prudent to avoid such situations whenever possible.

V. TRANSFERS OF GOODS

In setting intercompany prices for the purchase and sale of goods (including raw materials, semi-finished products and components and finished goods), the Draft Circular outlines the following alternatives:

- Comparable, uncontrolled price
- Cost-plus
- Resale price
- Other methods

Comparable, uncontrolled price

The Circular notes that the "comparable, uncontrolled price" (a price established in the same market and circumstances by parties who are dealing at arm's length) is the primary method in the view of Revenue Canada, of other tax administrations, and of the OECD (paragraph 12 of Draft Circular). As noted in the 1979 OECD report, such transactions may include sales involving the particular taxpayer, provided one of the members to the transaction is an unrelated party.

The Circular admits that application of this method tends to be restricted by the difficulty in establishing that the product involved, the market, the credit terms, reliability of supply and other pertinent circumstances, are indeed comparable. Paragraph 12 of the Circular also notes that, if this method is to be used, variations in the respective circumstances should be minor or capable of quantification on some reasonable basis; also, that the use of the method precludes the allocation of related product development costs, overhead or royalties unless such charges are also made to unrelated parties which have paid the same price.

Where appropriate comparables are not available and the taxpayer must revert to any other methods described below, the Circular recommends that a thorough functional analysis of the activities and contributions of all group members be carried out which would identify and evaluate, with respect to a given product or product line, the role and contribution of each member, including the economic risks assumed and the degree of responsibility for engineering and production, ongoing research, administration, marketing, etc. (paragraph 13 of Circular).

Cost-plus and resale price methods

The secondary methods for determining a reasonable arm's length price as set out in the Draft Circular (consistent with the 1979 OECD report) are the cost-plus and resale price methods (cost-plus calculations starting with the transferor's cost of the goods and adding an appropriate mark-up, and resale price calculations working backwards from the transferee's eventual resale price and subtracting therefrom an appropriate margin or gross profit).

12. Paragraph 19 of 1979 OECD report.
13. Paragraphs 66 and 67 of the 1983 draft stated in part that "There is no explicit or implicit offset in the Canadian system; a taxpayer cannot, for example, explain his high import prices by reference to favourable royalty rates.", and that the clean price approach, wherein each type of intra-group transfer would be identified and subject to separate evaluation, . . ."will minimize the risk that a multinational group may suffer double taxation in respect of its Canadian operations".
14. Assuming that the activities of the non-resident do not constitute the carrying on of business in Canada, either based on the facts or within the extended meaning in section 253 of the Act or, in the alternative, that the exempting provisions of the "business profits" section of any applicable treaty are applicable.
15. Supra footnote 13.

Paragraph 15 of the Circular notes that, under the cost-plus method, "cost" must be computed in accordance with generally accepted accounting principles or normal accounting practices in the industry in Canada, even though some other computation of "cost" may be acceptable in the foreign country. The same paragraph notes that, in determining cost, Revenue Canada will not recognize depreciation based on replacement or current market value of capital property used in the manufacturing process. Finally, it is noted that the method for determining cost will impact the reasonableness of a particular mark-up. For instances, if cost includes only direct production costs, an appropriate mark-up would be an amount that is sufficient to cover normal indirect overhead and general and administrative expenses in addition to a reasonable profit contribution, whereas a lower mark-up would be indicated if a full absorption costing method is used.

The Circular notes that the resale price approach is the most appropriate method in those cases where no arm's length comparables are available and where the purchaser adds relatively little value to the product, and suggests that, the greater the value of the functions performed by the purchaser, the more difficult it will be to determine an appropriate transfer price by backtracking under this method.

Other methods

Paragraph 17 of the Draft Circular states that, consistent with the recommendations of the OECD, other methods may be employed in support of the above three methods or in circumstances where none of the methods is appropriate.

The 1979 OECD report sets out several types of "other methods" which might be considered, including comparable profits (comparison of an enterprise's overall performance with that of other similar enterprises in the same or similar circumstances), and comparable yields (comparison of return on capital with that of enterprises carrying on similar activities and requiring the same kind of capital investment).[16] The Draft Circular does not refer to any of the foregoing methods, and instead suggests a somewhat confusing "check-point" approach. Paragraph 18 of the Circular states that, under this approach, a transfer price might be required to satisfy, within reasonable limits, criteria based on the following four check-points:

- Cost of direct materials
- Full cost of production
- Value as a replacement part
- Value as a fraction of the market value of the whole product

It is difficult to understand exactly what Revenue Canada has in mind by the above, and it is understood that this particular section of the Draft Circular is to be clarified.

Earlier drafts of the Circular had referred to functional analysis as a possible "other method" and had noted that, under this approach, the ultimate profit from a particular product would effectively be apportioned amongst the group members according to the relative value and importance of the functions performed by each. While this reference has been deleted, the Circular does (as noted further above) recommend that a functional analysis of the activities of all group members be carried out whenever appropriate comparables are not available, and where the taxpayer must therefore revert to any of the other methods discussed in the Circular (cost-plus, resale price or other). It remains the common practice of many assessors in Revenue Canada to consider a functional analysis or bottom line approach for testing the validity of specific pricing practices, in situations where valid arm's length comparables simply cannot be identified.

The Indalex decision

Is this basic premise – that one should refer to the comparable, uncontrolled price method whenever feasible – valid under Canadian tax law? As indicated previously, the jurisprudence is scarce and provides little guidance. The answer may turn in part on whether the Canadian courts would ultimately accept the position put forward in the Circular that subsections 69(2) and (3) effectively require the application of the transaction-by-transaction approach, as opposed to more general methods involving overall profitability of the Canadian taxpayer.

The recent decision of the Federal Court – Trial Division in *Indalex*[17] provides some long-awaited guidance in the area of international transfer pricing, including the use of the comparable, uncontrolled price method. In that case, Indalex Limited ("Indalex"), a Canadian taxpayer, had purchased aluminum billet from Pillar International Services Limited ("Pillar"), a company established in Bermuda. Indalex and Pillar were both controlled by a company resident in the United Kingdom. While Indalex and Pillar were therefore related parties for Canadian tax purposes, there was a significant minority interest in Indalex (apparently 42%).[18] Pillar purchased aluminum from an unrelated Canadian supplier and sold to Indalex (Pillar also fulfilled a similar purchasing function for affiliates in other jurisdictions, such as the United Kingdom and Germany). Pillar invoiced Indalex the same price which it paid the arm's length Canadian supplier; however, certain discounts from the Canadian supplier were retained by Pillar, and Revenue Canada contended inter alia that, having regard to these discounts, the price paid by Indalex to Pillar was not "reasonable in the circumstances" as required by section 67 and subsection 69(2) of the Act.

16. Paragraphs 70 to 75 of 1979 OECD report. At the same time, the 1979 OECD report emphasized that all such approaches have considerable problems and should be used with care and, as noted above (supra footnote 11 and related commentary), did not endorse "global" methods whereby group profits are allocated to each member based on some type of internal criteria, such as respective costs or turnover.
17. Supra footnote 9.
18. The Court did not appear to give any weight to the question of the minority interest in arriving at its decision.

The Court first noted that the price paid to the arm's length supplier by Pillar was negotiated on a market-by-market basis (Canada, the United Kingdom and Germany being separate markets). In reviewing the question of a reasonable arm's length amount, the Court then turned to arm's length comparables, but essentially could find none. While two other independent purchasers were identified, each was dismissed as a valid market comparable on the basis that Indalex purchased three times as much product as the two other companies combined and, in addition, on the basis that one of the companies was in considerable financial difficulty during the years in question. The Court accepted the position that the closest arm's length comparable therefore related to transactions between Pillar and the Canadian supplier, and then essentially relied on "other methods" to determine what adjustment if any should be made for purposes of equating an Indalex purchase from Pillar, to a Pillar purchase from the Canadian supplier.

Revenue Canada adduced expert evidence to the effect that the reasonableness of the price charged to Indalex by Pillar could be reviewed with reference to the profit margin which Pillar earned on such sales relative to mark-ups received by arm's length firms performing similar functions, or alternatively could be ascertained by indirect comparison to the return on investment. The indirect method had been chosen because of the "uniqueness" of the situation, and relative rates of returns of banks and utility companies were reviewed as having risk factors comparable to Pillar. Madame Justice Reed concluded that this analysis was ". . .useful as a bottom line approach. . .", but was not convinced that the analysis, in and of itself, demonstrated a lack of reasonableness.

The taxpayer had argued that the additional amount it paid to Pillar (being the amounts of the discounts in question) were justified on the basis of certain economic benefits which flowed to it as a result of the arrangement. After questioning the significance of these "alleged benefits", the Court concluded that the taxpayer had not discharged the burden of proof on it to demonstrate that the price it paid was reasonable in the circumstances. While the judgment is not entirely clear on this point, it appears that the Court adjusted the purchase price to disallow an amount equal to 80% of the discounts.

The *Indalex* decision essentially supports certain of the positions taken in the Draft Circular, but illustrates the difficulties which one so often encounters in practice. The Court did first refer to arm's length comparables but, finding none on which it could rely, was essentially required to decide the issue using "other methods". It is understood that an appeal has been filed with the Federal Court of Appeal, and additional clarification may accordingly be forthcoming.

Value for duty

The value established for Canadian import duty purposes often differs from that accepted as a reasonable arm's length price for purposes of the Act. Revenue Canada states that, while value for duty under the current provisions of the Canada Customs Act resembles that outlined in the Circular and may now be closer to transfer prices acceptable for income tax purposes than has been the case in the past, differences do remain, and that it is under no obligation to accept value for duty in the income tax context (paragraph 20 of Draft Circular).

VI. TRANSFERS OF SERVICES

As a separate section, the Draft Circular provides detailed comments with respect to the following categories of services:

- Management or administration
- Research and development
- The use of intangibles

As a general comment, Revenue Canada notes that it is concerned that a Canadian taxpayer not absorb the same charge twice, once as an element of transfer pricing for a specific product and again as a separate charge for services, for instance under intercompany royalty or cost sharing arrangements (paragraphs 1 and 51 of Draft Circular).

Management or administration services

In dealing with management or administration services, the Draft Circular generally concentrates on benefit and allocation matters (discussed below), and is not particularly expansive in respect of acceptable methods for establishing the quantum of a reasonable intercompany charge for such services. The implication is that, except with respect to royalty rates, charges for such services should relate to a sharing of centralized costs on some acceptable basis, and not to the arm's length price which would be paid between unrelated enterprises. The author would submit that this emphasis on a cost-oriented rather than open market approach will, in certain circumstances, be inconsistent with the reasonable arm's length test set out in subsections 69(2) and (3) of the Act; neither does it accord with the general approach of the 1979 OECD report, or with comments included in the supplemental OECD report issued in 1984.[19]

Central management or administrative expenses are categorized as follows in the Circular:

(1) Expenses that are incurred by the parent company in its "custodial" capacity, i.e. as a shareholder managing its investments in subsidiaries rather than in the provision of services (the Circular notes that such expenses should be borne by the parent directly);[20]

19. A report on "The Allocation of Central Management and Service Costs" was prepared by the OECD Committee on Fiscal Affairs and included in the 1984 publication "Transfer Pricing and Multinational Enterprises: Three Taxation Issues".

20. The proposition that custodial services should be borne directly by

(2) Expenses that are clearly incurred for the benefit of a single company in the group; and
(3) Expenses that are incurred for shared services and facilities for the benefit of a number of companies in the group.

The Circular states that the only category that presents an allocation problem is that described in (3) above and, in addressing the situation where centralized costs are paid by a non-resident person, provides two guidelines for the allocation of such costs to a related Canadian taxpayer. Firstly, the Canadian taxpayer must be in a position to derive "a real benefit" from the services (e.g. expenses should not be allocated which represent a duplication of services already provided by Canadian personnel); secondly, any allocation should be based on a comprehensive review of the central expenses involved (paragraphs 24 and 25 of Draft Circular).

With respect to the requirement that the Canadian taxpayer derive a real benefit from the services, the general position outlined in the Circular appears reasonable and is really only a restatement of the general "income earning" test which applies to most deductions under the Act. The problem which invariably arises, however, is how one demonstrates a connection between central services and activities carried out by the headquarters of a multinational group, and the benefit therefrom (immediate or future) to the Canadian taxpayer. Stated in another manner, where does one draw the line between custodial expenses incurred by a non-resident parent company for its own benefit, and costs for central co-ordination and control incurred at least in part for the benefit of other members of the group?

The author would suggest that Revenue Canada's assessing practice in the past has often been too restrictive in determining which control and supervisory expenses do in fact benefit various group members. For example, it is understood that certain District Taxation Offices of Revenue Canada have at times proposed that the following functions of a non-resident parent company should be considered as general supervisory services performed for its own benefit:

- Determination of compensation for personnel of the Canadian subsidiary, including benefit and pension plans.
- Attendance at directors' meetings of the Canadian subsidiary.
- Investigation of new markets and products which may be located in Canada, or activities relating to establishing production facilities in or sourcing sales to Canada.
- Involvement in financing for expansion of Canadian facilities, including visits to Canadian bankers.
- On site assessment of operations in Canada and specific problem solving.

The above-type of assessing posture is in certain instances contrary to the recommendations of the 1979 OECD report,[21] and it is to be hoped that Revenue Canada will adopt a more balanced approach in future in applying the guidelines of the Draft Circular.

The second guideline in the Circular relates to allocation. It is noted that an allocation of shared costs should be based on a comprehensive review of the central expenses carried out in advance of the allocation, and that the basis used must be available for examination by Revenue Canada before the allocation will be accepted. An example of an acceptable method outlined in the Draft Circular would be an allocation based on an estimate of actual time spent on duties performed for each entity. The Circular notes that, while the basis of allocation may not be reviewed each year by the taxpayer, such reviews should be made at intervals of not more than two or three years, and the taxpayer should provide an analysis of any relevant changes for the year in question back to the most recent comprehensive review (paragraph 25 of Draft Circular).

Revenue Canada's preference for an allocation based on an advance comprehensive review held at regular intervals, while understandable, is not a requirement under the Act. Under Canadian tax law, the burden of proof is on the taxpayer to demonstrate that the Minister's assessment is incorrect,[22] and if a transfer pricing issue is ultimately litigated in the courts, the onus will be on the taxpayer to demonstrate that the reasonable arm's length test has been met. While a comprehensive review carried out in advance of the allocation would of course be useful to the taxpayer in such a situation, it is unlikely that a decision would turn on this point in and of itself.

Three other issues should be noted in respect of management or administration charges – mark-ups, allocation of non-deductible expenses, and Part XIII considerations – each of which is discussed below.

The question of mark-ups on management and administration fees has been a contentious issue in Canada for some time. However, Interpretation Bulletin IT-468 was published by Revenue Canada in final form during 1981 and notes that:

> In considering the reasonableness of the fee or charge for purposes of section 67 and subsection 69(2), the Department is prepared to recognize a reasonable mark-up or profit on specific expenses incurred by the non-resident in performing the services for the benefit of the Canadian payer.

The Draft Circular on the other hand takes a somewhat different (and non-descript) approach by stating, at paragraph 27, that:

> Generally, there is no profit element in shared costs charged to Canadian branches and subsidiaries. However, the Department has seen examples where a reasonable mark-up on charges for services from a non-resident related company which is in the business of

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the parent company accords with the general rationale adopted in certain decisions in other jurisdictions, for example the decision of the United Kingdom Court of Appeal in Robinson v. Scott Bader Co. Ltd., (1981) STC 436; also, the decision of the United States Court of Claims in Young & Rubicam, Inc. v. the United States, 69-1 U.S. T.C. paragraph 9404.

21. See for example paragraphs 158 and 159 of 1979 OECD report.

22. See for example the 1948 decision of the Supreme Court of Canada in Johnston v. Minister of National Revenue (3 DTC 1182).

providing such services has been made and the total charge has been allowed as a deduction under Part I.

The question of mark-ups is of course only one aspect of the more fundamental question discussed above as to whether an open market approach for valuing intercompany management or administration charges would not be more consistent with the provisions of the Act. In any event, it is suggested that Revenue Canada should address the apparent contradiction between Interpretation Bulletin IT-468 and the Draft Circular before the Circular is issued in final form.

A second issue relates to the inclusion in an overall management or administration charge, of an allocation for expenses which would not have been deductible by the Canadian taxpayer had they been paid directly (for example, certain club dues or capital costs, depreciation which is not based on the Canadian statutory scheme set out in the Act, etc.). The 1983 draft circular had included a comment that, where a fee for a management or administration service constitutes a reimbursement of specific expenses, any portion of the fee charged to a Canadian taxpayer which relates to the foregoing types of non-deductible expenses would in turn be disallowed as a deduction. The current Draft Circular is silent on this issue. However, certain authors have argued in the past that any attempt by Revenue Canada to disallow a portion of a management or administration fee with reference to the nature of underlying costs would be incorrect and would reflect a misunderstanding of the legal relationship as principal rather than agent where a foreign parent company performs services and charges an amount to a Canadian subsidiary.[23]

A third and final issue arises with respect to possible Part XIII tax on the non-resident. Under Part XIII of the Act, a non-resident of Canada is generally taxed at a flat rate of 25% (subject to reduction by treaty) on the receipt of prescribed amounts from a Canadian taxpayer.[24] The full amount of management or administration charges is subject to these provisions, unless the amount represents a reimbursement of a specific expense incurred by the non-resident for the benefit of the payer, or alternatively was paid to an unrelated non-resident for a service performed in the ordinary course of a business carried on by the non-resident.[25] However, the Draft Circular notes that most modern income tax treaties including the 1980 Canada-United States convention, do not require that management fees be treated as anything other than a component of industrial, commercial or business profits. Therefore, such amounts are normally taxable only in the home jurisdiction of the recipient (except in the particular situation where the amounts can reasonably be attributed to a permanent establishment of the recipient in the other jurisdiction), and that the previous importance of the Part XIII question to management fees has been greatly reduced.[26]

Reseach and development

Under the heading of "research and development", the Draft Circular addresses the situation where such services are performed centrally and results are made available for the benefit or potential benefit of various members of the corporate group. A separate section entitled "use of intangibles" (discussed below) reviews the situation where the company carrying on the research and development retains the benefits therefrom.

The Circular provides little guidance with respect to allocation of research and development carried out for the direct benefit of various group members, noting simply that it is not possible to specify any preferable method, and that the method utilized should be appropriate to the circumstances in each case. The Circular is somewhat more lucid on the question of mark-ups, and distinguishes between situations where research and development is treated as a "cost center" as opposed to a "profit center". With respect to the former, the Circular notes that, if the arrangement is in the nature of a cost-sharing arrangement where resources are pooled for convenience or economy and each participant bears its fair share of the net cost in return for a share of the usable results of the research and development, there would be no mark-up or profit. The Circular goes on to state that, if on the other hand the facility is treated as a profit center, then the amount charged to the Canadian taxpayer would be based on a reasonable arm's length price, which normally would not exceed a fair share of the research and development expenses marked up at a reasonable rate.

There appears to be little basis in the Act to support the position in the Circular that the deductibility of a mark-up turns on whether the research and development facility is, further to an internal business deci-

23. For example, see Boidman, supra footnote 2, p. 417.
24. The application of Part XIII tax to management or administration fees or other prescribed types of income may in certain circumstances result in additional provincial corporate income taxes to the Canadian taxpayer in the province of Ontario, if the taxpayer carries on business in that province. It should also be noted that where payments which might otherwise be taxable under Part XIII of the Act are made to a non-resident person who carries on business in Canada and the payments may reasonably be attributed to that business, the non-resident may be subject to the general provisions of Part I rather than Part XIII (Regulation 805(1) to the Act). However, unless the person making the payments is authorized by Revenue Canada (under Regulation 805(2)) to make such payments without any deduction under Part XIII, he may be personally liable if the non-resident recipient is subsequently found not to have been carrying on business in Canada.
25. Subsection 212(4) of the Act.
26. It should be noted that, notwithstanding possible ultimate exemption by treaty, and in the absence of obtaining a waiver from Revenue Canada, a 15% retention requirement may apply under Regulation 105 of the Act in respect of payments to a non-resident person for services rendered in Canada (a similar 9% retention requirement may apply under Regulation 1015R8 to the Quebec Taxation Act where such services are rendered in the province of Quebec). These amounts would then be refunded when the non-resident files Canadian tax returns and establishes that no ultimate liability exists. While Revenue Canada holds to the view that his retention requirement applies notwithstanding possible treaty exemption, one could argue that this view is not consistent with the decision of the Tax Review Board in The National Indian Brotherhood v. Minister of National Revenue (75 DTC 110). This decision was reversed on appeal to the Federal Court – Trial Division (78 DTC 6488)); however, the Court found in that appeal that the taxpayer did not qualify for the exemption sought, and was therefore not required to specifically address the retention issue.

sion, treated as a cost or profit center. The position also seems inconsistent with the 1979 OECD report.[27] The issue may, however, be academic. Most payments or reimbursements to non-residents in respect of research and development are taxable to the non-resident under Part XIII of the Act. However, an important exception applies for payments made under a bona fide cost-sharing arrangement, under which the person making the payment shares research and development expenses on a reasonable basis with one or more non-resident persons, in exchange for an interest in the results of the research and development.[28] It appears that any mark-up may endanger this exemption (and the Draft Circular so indicates at paragraph 36) and, as a matter of practice, such mark-ups should normally be avoided.

Use of intangibles

Paragraphs 37 to 44 of the Draft Circular address the situation where a particular company carrying on research and development retains the benefits therefrom, and access to the knowledge is provided to other group members through licensing agreements. Such arrangements may include a wide range of items, such as patents, inventions, formulae, processes and similar types of intellectual property, trademarks, trade names, brand names, franchises, licenses, special commercial or industrial information and expertise, copyrights and exclusivity rights.[29]

The Circular notes that, ideally, intra-group royalty rates should be determined with reference to arm's length comparables. At the same time, it acknowledges (at paragraph 42) that many multinational groups market their products entirely through branches and subsidiaries, with the result that arm's length comparables will often not exist. The Circular suggests that, in that event, one should draw comparisons with royalty rates in the same or a similar industry, and that the following items might be relevant in determining an acceptable royalty rate:

- Prevailing rates in the industry.
- Terms of the license, including geographic limitations and exclusivity rights.
- Singularity of the invention and the period for which it is likely to remain unique.
- Technical assistance, trademarks and "know-how" provided along with access to the patent.
- Profits anticipated by the licensee.
- Benefits to the licensor arising from sharing information on the experience of the licensee.

While the above types of general guidelines may be of some use to taxpayers in certain situations, what might be more helpful would be the setting of safe haven rates which Revenue Canada would undertake to not challenge. The possible use of such rates was discussed in a paper given by a senior official of Revenue Canada at the 1982 Annual Conference of the Canadian Tax Foundation.[30] In that paper, it was noted that Revenue Canada was considering whether it might be possible to develop standard international safe haven guidelines for Canada and that, while this would certainly minimize disputes between taxpayers and the tax authorities as well as competent authority problems, Canada had certain reservations, including the tendency of such rates to be arbitrary and to become obsolete as business conditions change. These reservations are consistent with the 1979 OECD report, which noted (at paragraph 16) that safe haven rates could open up an undesirable scope for tax avoidance and that the report would make no recommendation on this topic.

Revenue Canada does have certain unofficial benchmarks or safe haven rates which are applied as a matter of assessing practice in certain circumstances. For example, the 1982 paper noted above stated that Revenue Canada does not question royalties of 6% or less on patented pharmaceutical products. In addition, it is understood that Revenue Canada is attempting at this time to develop safe haven ranges for commission rates on sales of pulp and is consulting with the pulp and paper industry in this regard.

VII. OTHER MATTERS

Taxation of the non-resident

Where as a result of a Revenue Canada tax audit of international pricing transactions, it is determined that the income of the Canadian taxpayer should be adjusted, a secondary issue which arises is whether any excess price charged by (or deficient price received from) the non-resident, should be viewed as a benefit

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27. For example, paragraph 119 of the 1979 OECD report states in part as follows:

> It is considered that, to the extent that the enterprise carrying out the research is relieved of risk because it could rely on its costs being met by the participating members of the group, then any profit mark-up should not take account of such risk and ought to be limited to a reward for its activities in organizing and managing the relevant research project or projects. But it seems difficult to accept that there would often be cases of genuine cost sharing arrangements in the arm's length situation. Accordingly, it would usually be right to look for a profit mark-up in cases of cost contribution arrangements.

Also, paragraph 120 states that:

> The treatment for tax purposes of contributions paid to a separately incorporated research entity by associated enterprises is also a matter to be considered. It would carry out research in the interest of other members and would not use the results of the R&D for its own purposes. It seems, therefore, that such research enterprises would ordinarily be required and allowed to charge costs plus a profit mark-up to reflect their efforts at organizing and managing the research.

28. Subparagraph 212(1)(d)(viii) of the Act. For Revenue Canada's views in this regard, see Interpretation Bulletin IT-303, paragraphs 29 to 32 inclusive. It will often be prudent to carefully structure such arrangements to ensure that the legal relationship of partnership does not arise and that various potential concerns are thereby avoided (such as whether each group member might, by virtue of its participation in the partnership, be considered to be carrying on business through a permanent establishment in the jurisdiction in which the research and development activities are centralized).
29. Subject to limited and specific exceptions, a non-resident of Canada is subject to tax under Part XIII of the Act on receipt of such amounts paid by a Canadian taxpayer, assuming the payments do not relate to a business carried on in Canada by the non-resident (supra footnote 24).
30. See Robertson, supra footnote 5, pp. 777-778.

taxable to the non-resident under the provisions of Part XIII of the Act.[31] Paragraph 46 of the Draft Circular indicates that, in such circumstances, relief from additional taxation under Part XIII may be considered if the monies are returned to the Canadian taxpayer.

As a matter of practice, assessors from Revenue Canada do in fact often forgo any Part XIII assessment in consideration for an undertaking that appropriate repayments be made within a reasonable period of time.

Financing arrangements

There are various technical provisions in the Act which deal with interest on loans and other indebtedness to or from non-residents, certain of which provide that interest be charged at a "reasonable rate" or at a "prescribed rate".[32] The Draft Circular does not specifically deal with intercompany interest charges, other than to note that credit terms and financing arrangements are among the factors which should be considered in evaluating intercompany prices.

VIII. CONCLUDING COMMENTS

As discussed above, the legislative provisions in the Canadian Act are brief and, subject to the recent *Indalex* decision, the jurisprudence has provided little guidance. The development of a Draft Circular is therefore to be welcomed by Canadian taxpayers and their advisors. At the same time, certain limitations remain.

First, while Revenue Canada generally endorses the 1979 OECD report, what has been set out in the Draft Circular is a summary of certain pricing guidelines and practices which the Canadian authorities intend to follow, and a more useful approach might have been to provide a detailed listing, by exception, of those portions of the 1979 OECD report which Revenue Canada does not endorse. Also, certain of the positions taken in the Draft Circular do not have clear legal support based on the specific provisions of the Act, and may ultimately be challenged by taxpayers. Finally, the lack of valid, arm's length comparables will mean that both taxpayers and the tax authorities will often have to revert to "other methods", including functional analysis or relative profitability. In the final analysis, reasonable transfer pricing remains very much a question of fact to be determined on a case by case basis according to the particular circumstances. Indeed, paragraph 10 of the Draft Circular states that:

> The quantum of income taxed in Canada should be consistent with the real profit contribution of the Canadian taxpayers involved, based on the economic functions performed and risks assumed by them. This result is achieved when non-arm's length transactions with non-residents are consistently made at reasonable arm's length prices. The determination of reasonable arm's length prices, while necessarily somewhat subjective, is nevertheless a question of fact, and therefore each taxpayer's situation must be examined on its own particular circumstances and merits.

The stakes in the international pricing area are high to both the taxpayer and the Canadian tax administration, and can be expected to increase. Canada's most important trading partner is the United States and, further to the proposed United States tax reform[33] (and resulting decreases in corporate tax rates in that country), there will be an incentive in many Canada-United States cross-border situations for profit to be earned in the U.S. On the one hand, U.S. parent companies of Canadian subsidiaries will often wish to repatriate the maximum possible amounts to the United States through transfer pricing mechanisms in view of the higher Canadian corporate tax rates. Similarly, it will often be preferable for U.S. subsidiaries of Canadian parent companies to earn the maximum possible proportion of group profit.[34]

Having regard to all the above, what appears certain is that further disputes will find their way to the Canadian Courts, and that judicial clarification of certain of the positions taken in the Draft Circular will be forthcoming.

31. Subsection 15(1), 56(2), and 245(2) and paragraph 214(3)(a) of the Act. Alternatively, liability to the non-resident might arise under the general provisions of Part I in those unusual situations where the amount in question reasonably related to a business carried on in Canada (supra footnote 24). Also note that in the recent *Indalex* decision (supra footnote 9) the Court found that, although the relevant provisions of subsection 245(2) lacked clarity, the intention of the Canadian Parliament was clear that the excess price in question should be taxed as a benefit to the non-resident and, in accordance with the demise of the strict interpretation rule and the substitution of the "plain meaning" or "modern" rule (that words are to be read in their entire context and in their grammatical and ordinary sense harmoniously with the scheme and object of the legislation, and the intention of Parliament), that the amounts in question were properly taxable to the non-resident.
32. For a discussion of certain of these provisions, see "Canada: The 1982 Changes to the Taxation of International Income", A.R. Lanthier, 37 *Bulletin for International Fiscal Documentation* 4, pp. 172-173 and 175.
33. The Tax Reform Act of 1986.
34. In this second situation, the application of United States withholding tax at a rate of 10% on "direct dividends" paid to the Canadian parent may still result in a less onerous tax burden than would have applied in many circumstances had the profits been earned directly by the Canadian parent. It should be noted that this general preference for earning profits in the United States could diminish were Canada to implement a similar reform and thereby reduce the corporate tax rate differential between the two countries. In this regard, Canadian Finance Minister Micheal Wilson announced by press release of 18 July 1986 that, in view of the proposed United States reform, the Canadian government intends to proceed with a review of options for comprehensive tax reform in Canada, and that officials of the Canadian Department of Finance have been instructed to examine such options and report to the Minister in the autumn.

U.S.A.:

Taxation of Intercorporate Transfer Pricing:

A Management Responsibility

By Guenter Schindler

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I. INTRODUCTION

Multinational corporations pose challenges of unusual dimensions. Of these, the taxation of intercorporate transfers is one of the most complex. Transactions between related entities, U.S. and foreign, are subject to intensive IRS scrutiny under Revenue Code Section 482[1] ("Section 482"). The pricing rules under this section are frequently misunderstood; the consequences of these misunderstandings manifest themselves years after the fact during tax audits.

Problems with the rules and IRS enforcement are a top management concern and create a tax planning dilemma. Expert economists can reduce uncertainty for corporate management through proper consideration of economic factors in transfer pricing determinations. An economic study also promotes a corporate dialogue between management and the tax function to guard against costly IRS audits.

II. BACKGROUND

Death and taxes are said to be certain. For U.S. companies with international operations, IRS scrutiny under Revenue Code Section 482 is an additional certainty. Audits of transactions between corporations and their controlled foreign operations have given rise to millions of dollars in additional tax payments.

Only 94 words long,[2] Section 482 is complex in that it addresses several policy issues at once: tax avoidance, assignment of income, general deduction theories, and notions about clear and proper reflection of income. The purpose of the law is to place intercompany sales of tangible and intangible property and performance of services on a parity with transactions involving unrelated parties, or at arm's length.

Treasury Regulations[3] interpreting Section 482 provide three methods to arrive at an arm's length price: the Comparable Uncontrolled Price, the Resale Price, and the Cost-Plus Methods.

A *Comparable Uncontrolled Price* is determined by comparing sales where the buyers and the sellers are not related through corporate affiliation – an uncontrolled sale.

A *Resale Price* is determined by comparing controlled and uncontrolled resales of products to establish an acceptable gross profit percentage . The resale price method is the most applicable when no processing or further product formulation is provided.

A *Cost-Plus* percentage is determined by comparing the mark-up on the cost of goods sold in uncontrolled sales. The cost-plus method applies best when manufacturing is involved.

The Regulations require that these three methods – the *Pricing Comparability Standard* – be applied in their stated order. The Resale Price can be used only if there is no comparable uncontrolled transaction. The Cost-Plus Method can be used only if the first two methods do not apply.

1. Internal Revenue Code of 1954, Section 482: "Allocation of Income and Deductions among Taxpayers".
2. "In the case of two or more organizations, trades or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion or allocate gross income, deductions, credits, or allowances between or among such organizations, trades or businesses, if he determines that such distribution, apportionment or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any such organizations, trades or businesses." Section 482, *Complete Internal Revenue Code of 1954;* Prentice Hall, 3 September 1982, Ed.: p. 25, 474-B.
3. Commerce Clearing House, Inc., *Income Tax Regulations*, as of 15 March 1983, Vol. 2, 1.482-2(e)(1)(ii).

These three pricing methods cannot always be applied. Some transactions are not duplicated in the open market place. Examples are the sale of crude oil and iron ore, which are sold mainly in-house due to the vertical integration of the industries. Another example is the transfer of intangibles. Rarely will a company sell its manufacturing or marketing know-how to both a subsidiary and an unrelated competitor.

Arm's length transactions may appear to be similar, yet they are often economically different in terms of underlying facts and circumstances. Differences affecting price are those of quality, quantity, terms of sale, and the market in which the sale takes place. According to the Regulations, differences must be isolated and quantified to permit pricing adjustments necessary to arrive at accurate comparisons. Adjusting for these differences involves subjective judgment and creates the potential for disagreements.

The pricing comparability standard must be used unless the taxpayer can prove that some other method is more appropriate, considering all facts and circumstances. Problems with the transfer pricing rules trouble corporations, tax administrators and the Courts alike. Many observers have questioned the effectiveness of the "arm's length" approach of the Regulations under Section 482. Efforts to apply the arm's length standard highlight the discrepancy between the rules and reality.

Recognizing the problems with the prescribed pricing methods, Treasury Regulations[4] offer an alternative to the comparable pricing standard, a poorly defined fourth method described simply as "Any Other Reasonable Method".[5] The lack of specific guidelines for this alternative method has become a major obstacle for corporate tax planners.

Despite the lack of specific guidelines, the fourth method is playing an increasing role in resolving transfer pricing disputes at both audit and appeals levels. The profit split (between parent corporation and foreign subsidiaries) has emerged as one of the most widely used "fourth methods".[6] Even the Courts have relied on the profit split approach to resolve issues too difficult to fit into the pricing comparability standard. The Tax Court, in its 1985 decision on Eli Lilly & Co. (84 T.C. No. 65), specifically emphasized "the method most widely recognized by the Courts is the reasonable profit split approach", as a fourth method.

Profits are the real issue in transfer pricing cases, and should be treated as such. The profit split meets the arm's length standard through profit comparisons, thereby escaping the constraints of the pricing comparability standard.

The audit experience of international companies has repeatedly been studied by the private sector and the government.[7] The most recent corporate survey, conducted in 1985 by Schindler Associates,[8] confirmed that the arm's length standard is not easy to apply (76%) and even the IRS is not able to follow its own rules (63%). The Regulations need clearer language (85%) and an administrative procedure for advance IRS approval would be helpful (66%).

Concerning the audits themselves, the Schindler Survey found that more than half (52%) of the reported issues were resolved at the IRS examination level and nearly 60% were resolved using other than the arm's length standard. Less than one third (28%) were resolved using the Comparable Uncontrolled Price Method.

III. A TAX PLANNING DILEMMA

The transfer pricing rules are complex, confusing, and at times inappropriate. Inconsistent and unpredictable IRS enforcement of the rules adds to the uncertainty surrounding their interpretation. Management's planning efforts are frustrated by the complexities of the rules and the unpredictability of IRS enforcement, creating real problems.

Lack of comparables

The recent House Hearings on Tax Reform[9] recognized, "A recurrent problem is the absence of comparable arm's length transactions between unrelated parties, and the inconsistent results of attempting to impose an arm's length concept in the absence of comparables".

The shortcomings of the arm's length pricing standard are compounded by its outmoded view of business operations. The pricing standard attempts to place intercorporate transactions on an "as if" unrelated basis. Multinational corporations don't operate "as if", they are unrelated to their foreign subsidiaries. The law views subsidiary corporations as totally separate – legally as well as economically – from their parent corporation, as well as from other subsidiaries of the parent. Although composed of legally separate

4. Ibid., 1.482-2(e)(1)(iii).
5. When the Regulations were released, Stanley Surrey, then Undersecretary of the Treasury, said: "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 this date, no further clarifications have been developed.
6. The use of the profit split method is explored in Schindler and Henderson, "Intercorporate Transfer Pricing: The Role of the Functionally Determined Profit Split Explored". *Bulletin for International Fiscal Documentation*, Vol. 39 No. 3, March 1985, pp. 108-112.
7. – Duerr, "Tax Allocations and International Business". The Conference Board, 1972.
- – Burns, "How IRS Applies the Intercompany Pricing Rules of Section 482: A Corporate Survey". 52 J. Tax 308 (1980).
- – General Accounting Office, "IRS Could Better Protect U.S. Tax Interests in Determining the Income of Multinational Corporations". September 1981 ("GAO Report").
- – Department of the Treasury, Internal Revenue Service, "IRS Examination Data Reveal an Effective Administration of Section 482 Regulations". Report to the Associate Commissioner (Operations) by the Assistant Commissioner (Examinations), April 1984 ("IRS Report").

8. Schindler and Henderson, "Intercorporate Transfer Pricing: 1985 Survey of Section 482 Audits". *Tax Notes*, Vol. 29 No. 11, 16 December 1985, pp. 1171-1177 ("Schindler Survey").
9. Report of the Committee on Ways and Means, House of Representatives, on H.R. 3838, Section V, Title VI(D)(2), pp. 423-424.

entities, multinational corporations operate as economic units. Cost minimization and economies of scale dictate that one entity perform functions or services on behalf of the corporate group. Purchasing, administration and research and development are examples of services best centralized.

Insistence on arm's length price comparisons fails to recognize the operating realities of multinationals.

No single price

The three prescribed pricing methods under the Regulations are used to determine "the" arm's length price. In the open market place, between willing buyers and willing sellers, a range of arm's length prices exists. Considerable price variations may be the result of differences in sales volume, turnover rates, promotional incentives, and consumer acceptance. The comparable pricing standard fails to recognize that dealing at arm's length often results in a price range, not a single price.

Uncertainty

The methods for establishing an arm's length price are complex and burdensome; the selection of comparables and adjustment factors (for level of market, product leadership, advertising and marketing expense) requires subjective judgment. The discretionary authority of the IRS is so broad and unpredictable that international corporations invariably remain exposed to transfer pricing adjustments.

IRS audits do not occur until years after the fact. The audit process itself may last for two or more years. Contesting IRS determinations through appeal and litigation can add ten years of continuing disquiet. For all this time, the only certainties taxpayers know are tax assessments, penalties, and legal fees.

Transfer pricing rationale is often overturned under audit. Disargreements with the IRS over the proper interpretation of the Regulations have led to litigation, where even the Courts have expressed difficulty interpreting the rules.[10]

Although some disputes are settled in the Courts – making the details public – the majority of transfer pricing issues is settled through negotiations between the corporate tax function and Revenue agents. Details surrounding these settlements do not reach public domain, providing no planning assistance for other corporations. The lack of uniform IRS enforcement causes additional uncertainty for the taxpayer.

Arbitrary elements

The IRS has broad power and discretion in determining the need for and the amount of income allocations. It has not been consistent in its application of the transfer pricing rules.

- For the industry-wide audit of pharmaceutical manufacturing operations in Puerto Rico, examiners were instructed to develop the cases on a predetermined cost-plus basis. This approach allowed for little consideration of operating differences from one company to another.
- Eli Lilly (84 T.C. No. 65) was subjected to the cost-plus pricing method for tax years beginning 1971. The company has used the resale price method dictated by previous litigation with the IRS. The change in pricing method led to 9 more years of litigation and another substantial tax assessment. Just because the IRS imposes one transfer pricing method in the course of an audit does not prevent it from imposing another during a subsequent audit.

Even the Courts seem arbitrary in their comparisons. In the U.S. Steel Case,[11] the Tax Court rejected the reliance on comparisons with transactions between unrelated parties in favor of a more appropriate basis. The Second Circuit Court, in reversing the Tax Court decision, used the subsidiary's transactions with unrelated parties, amounting to a mere 5% of sales, to determine transfer pricing for transactions with its parent corporation, covering 95% of the subsidiary's total sales.

Unfairness

In any income allocation dispute with the IRS, the taxpayer must prove the IRS allocation to be unreasonable, arbitrary and capricious. The corporation must further prove its pricing methods and pricing adjustments to be the most appropriate under the Regulations. The IRS does not have to support its income allocations to that same extent.

Whenever a taxpayer sues for a refund, the burden of proof includes determining the amount of the refund claimed. A taxpayer may lose his case in whole or in part for failure to prove, for example, the "proper amount of allocation", or the "proper royalty rate". Facing this burden of proof has been a strong inducement for corporations to settle transfer pricing disputes at the audit level.

IV. ROLE OF ECONOMISTS

Economists expert in international taxation can assist corporate management to assure that economic factors underlying intercorporate transactions are properly considered in transfer pricing determinations. Transfer pricing is not purely tax motivated. Operating objectives as well as relevant economic facts and circumstances weigh heavily in management's pricing determinations to controlled foreign operations.

Corporations have different management styles and

10. See, for example, DuPont, 608 F. 2d 445 (Ct. Cl 1979); PPG Industries, 55 T.C. 928, 1970; Lufkin Industries, 468 F. 2d 805 (5th Circuit 1972), rev'g 30 T.C.M. 400, 1971.
11. 617 F.2d. 942 (2d. Cir. 1980), rev'g 36 T.C.M. 586 (1977).

operating goals. Examples of objectives that directly impact on the pricing and profits of multinational corporations are market penetration, establishing market position, and development of world markets. Pricing of goods and services between related entities must reflect underlying economic realities. Failure on the part of management to understand the tax consequences of transfer pricing results in costly adjustments to taxable income.

The IRS employs economists to advise audit teams with transfer pricing cases and with the development of arm's length comparables. The role of IRS economists is frequently confined to quantifying differences in fact and circumstances with transactions in the open market place. Their analyses of underlying economic facts are used to determine the appropriateness, if not the amount, of income allocations.

The significance of the role of economists within the IRS is reflected not only in the magnitude of the allocations they have developed, but also in their decentralization and expansion into field offices. The Revenue Manual has recently been revised, making referrals to economists mandatory above a certain tax deficiency.

The IRS is not alone in recognizing the contribution of economists. The GAO Report specifically recommended that the IRS uses its economists more extensively to ensure better application of Section 482 in its audits. The IRS Report asserted more frequent involvement of economists with the development of these issues.

Prompted by the IRS' success with its economists, corporate management has sought assistance from economists expert in the taxation of intercorporate transfer pricing. Economists examine issues outside of tax or transfer pricing considerations to help corporations plan or defend transfer pricing rationale. Economists can help establish pricing systems that reflect the realities of the industry and the market place, giving management greater certainty that its transfer pricing can withstand IRS scrutiny.

The benefit of using independent economic experts involves more than a working knowledge of the rules and the problems under Section 482. Outside experts encourage a dialogue between corporate management and the tax function. Tying corporate objectives to their tax consequences is essential for a defendable transfer pricing rationale.

Outside counsel can perform an important role in the planning phase. Involvement of a tax economist with the establishment of transfer pricing can serve as a deterrent against IRS assessments. In cases in which additional assessments are being imposed, this type of prior planning provides strong support for the taxpayer's position.[12] Proper documentation of intercompany transfer pricing rationale helps defend against IRS adjustments.

In addition to helping management develop defendable transfer pricing, economists assist corporations through audit and appeal processes. The importance of economic analysis is reflected in the testimony of expert economists in transfer pricing cases brought to litigation.

V. FUNCTIONAL ANALYSIS/PROFIT SPLIT

The best use for the skills of a tax economist is in the development of a functional analysis. The functional analysis is a careful review of the entire corporate operation, based on a working knowledge of the industry and the particular corporation under examination. It permits due consideration of each corporate member's involvement in terms of capital, labor, and exposure to economic risk. The analysis evaluates economically significant functions that give rise to profits. Some are performed by individuals such as sales, engineering and accounting services; others 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 basic issue addressed in Section 482 is which country may tax what portion of the profits earned by two or more related entities dealing with one another. The problem is to ascertain if related parties have reported the profits earned through controlled transactions without shifting income.

While the Regulations are mute on the subject, the IRS recognizes the role of the functional analysis as a fourth method. The Manual[13] directs its personnel to evaluate the respective functions performed within the corporate group. The Manual states that all, or virtually all Section 482 cases can be reduced to seven basic questions:

- What was done?
- What economically significant function was performed?
- What economic risk was assumed?
- Who performed each function and assumed each risk?
- What is the economic value of each function performed by each party?
- Are there any valuable intangibles used?
- Who developed the intangibles and are they being paid for their use?

These questions do not easily elicit satisfactory answers. In the context of the arm's length pricing standard, the functional analysis is limited to quantifying differences in fact and circumstances that distinguish related from unrelated transactions. It is also the economist's most effective tool to offer an alternative to the three comparable pricing methods prescribed by the rules. Economic analysis can develop or assess transfer pricing rationale when transactions are not duplicated in the open market. The functional analysis looks past tax motives to consider the economic facts underlying intercorporate transactions.

The functional analysis focuses not so much on the detailed methodology or the shortcomings of the arm's length standard, but on the reasonableness of the pro-

12. See Donnelly, "Eliminating Uncertainty in Dealing with Section 482", *The International Tax Journal*, Vol. 12 No. 3, Summer 1986.
13. *Internal Revenue Manual*, at IRM 5233, S. 523.8 ("The Manual").

fit distribution. The necessary understanding of the significance of the transfers and the role played by the different corporate entities does not become diluted by an exhaustive search for an arm's length price comparison. The objective is to determine if the amount of income retained by a related entity is equal to the amount it would have earned had the members of the corporate group dealt with each other at arm's length.

The functional analysis has been singularly successful in resolving transfer pricing issues. It offers corporate management an opportunity to avoid the hazards of litigation, which are potentially more costly than the tax issue itself in terms of the time and energy involved, and the threat of making public relevant corporate data.

The effectiveness of this approach, however, hinges on understanding the economic significance of the functions performed by each party. The Revenue Manual acknowledges that the functional analysis is complex and may require the involvement of an economist. This approach requires an economic study and analysis normally outside of the expertise and knowledge of the corporate tax function or revenue agents. It should therefore be developed by an economist familiar with the taxation of intercorporate transactions.

VI. NEED FOR REFORM

The comparability pricing standard and the realities of intercorporate transactions are difficult to reconcile. The Revenue Manual, the IRS in practice, and the Courts offer relief from the constraints imposed by the strict price comparability standard. So should the Regulations.

Reform in this area has repeatedly been suggested. The recent growth of American business interests abroad and the increasing presence of foreign operations in the United States give new urgency to the need for expanded guidelines. Expansion of the Regulations would eliminate the inconsistent IRS enforcement of Section 482.

The GAO Report, in recommending improved IRS enforcement of Section 482, argued for reform. More recently the Unitary Taxation Working Group[14] was critical of the application of the arm's length standard to multinational corporations. In April 1986, the American Bar Association[15] suggested changes in the transfer pricing rules.

The ABA Recommendation proposes two major revisions:

(1) Retain the comparable uncontrolled price method, but subdivide it into "comparable" and "parallel" uncontrolled prices. Create a second "reasonable price method" to include the present Resale, Cost-Plus and Other Methods, without a priority of application requirement.

(2) Provide three safe harbor provisions to assure IRS acceptance of intercorporate transfer pricing. To overturn transfer pricing in compliance with the safe harbor provision, the IRS would bear the burden of proof.

The Schindler Survey concluded that reform of the transfer pricing rules was needed, and made several specific recommendations.

- Treasury should revise its transfer pricing rules to include other than the arm's length standard.
- Treasury should define more clearly the "other reasonable method".
- Treasury should include the functionally determined profit split under the fourth method.
- Treasury should include IRS in the burden of proof requirements.
- Corporations should continue to plan carefully and document their transfer pricing .
- Corporations should include the tax consequences in planning their intercorporate transfer pricing.
- Corporations should involve expert economists to assure proper consideration of economic factors in transfer pricing determinations.

Japan has recently adopted transfer pricing legislation[16] without the shortcomings of Section 482.

The Japanese transfer pricing law is designed to be neutral in its effect on international economic activities. The law relies on the arm's length pricing standard, but allows for a reasonable range of prices. There is no priority of application rule among the three pricing methods. In situations where these pricing methods cannot be applied, other reasonable methods, including a profit split, are provided.

The law offers guidelines to minimize excessive and costly administrative burdens on the taxpayer, including a system for advance approval of taxpayers' transfer pricing.

It appears that Japan once more has adopted a Western concept, but not without perfecting it first.

VII. CONCLUSION

The taxation of intercorporate transactions presents a dilemma for management of international corporations. The tax consequences of transfer pricing between U.S. taxpayers and their related foreign operations are shrouded in uncertainty.

More specific guidelines are needed to reduce corporate frustration in establishing transfer pricing rationale. Expert tax counsel can assure proper consideration of economic factors in planning international operations. A corporate dialogue between management and the tax function, and proper documentation, are essential for an effective defense against IRS assessments.

14. Dexter, "A Comment on the Unitary Working Group's Deliberations and Product", *Tax Notes*, Vol. 29 No. 4, 28 October 1985; p. 425.

15. American Bar Association, "Administrative Recommendation No. 1968-8", Committee on Affiliated and Related Corporations, 15 April 1986 ("The ABA Recommendation").

16. As presented at the International Tax Institute, Inc., 25th Anniversary Seminar: "Competent Authorities from Six Countries"; 2 June 1986 in New York. The Japanese Section was presented by Toshihiro Kiribuchi, Deputy Commissioner (International Affairs), National Tax Administration, Japan. The Special Taxation Measures Law, Section 66-5, became effective April 1986.

THE NETHERLANDS:

Transfer Pricing

By Peter Dekker

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INTRODUCTION

In Dutch domestic tax law there are no specific (statutory) provisions dealing with transactions between related companies unlike, notably, the United States (IRC, sec. 482) and the Federal Republic of Germany. The Federal Republic, in fact, has introduced administrative principles containing elaborate rules pursuant to which the German tax authorities must determine whether or not intercompany transactions have met the arm's length test (Circular of 23 February 1983, of the Ministry of Finance of the Federal Republic).

Under Dutch tax law, however, the principle is commonly accepted that prices for the sale of goods and rendering of services between affiliated companies should be calculated on an arm's length basis, i.e. determined as if the companies were entirely independent parties.

LEGAL BASIS

The legal basis for the arm's length principle is found in two statutory provisions which both contain basic concepts of Dutch tax law.

Article 7 of the Dutch Income Tax Act 1964:

> Profit is the amount of total gains that, regardless of description and form, are derived from business.

Article 10(a) of the Corporate Income Tax Act 1969:

> In computing the profit the following items shall not be deductible:
> (a) direct or indirect distributions of profits, regardless of description or form, subject to the exceptions mentioned in article 9.[1]

One of the very rare instances in which the law contains a specific provision dealing with intercompany relations can be found in article 23(d) of the Corporate Income Tax Act. This provision stipulates that the allowance subsidy – a tax incentive to stimulate investments in capital assets – is not granted with respect to investments in capital assets which have been purchased or otherwise acquired from affiliated companies as defined.[2] This provision was introduced to deny the allowance on transfers of capital assets between related enterprises for no purpose other than obtaining (for the second time) the benefit of the allowance subsidy. The tax inspector may grant an exemption if the transfer takes place for bona fide business reasons.

Furthermore, the transfer pricing issue is limited by the general doctrine that the Revenue may not evaluate the soundness of the business decisions as such. In combining the general doctrine and the statutes quoted above, one comes to the basic conclusion that the Dutch Revenue must accept any method of intercompany transfer pricing adopted by the multinational enterprise operating abroad and in the Netherlands, unless the Revenue is able to establish that the method of intercompany transfer pricing applied by the multinational enterprise results in an indirect profit distribution by its Dutch associated enterprise.

1. Article 10 of the Corporate Income Tax Act reads as follows:
The following items shall not be deductible from profit:
   a. direct or indirect distributions of profit, regardless of description and form, that are not covered by Article 9;
   b. distributions not coming within Article 9 that are made pursuant to the articles of association, foundation charter of similar instruments, unless said distributions are in the nature of business costs;
   c. interest on entrance fees of a cooperative society, interest on shares in a guarantee fund, and, in general, any compensation for capital contributions by incorporators, shareholders, members, participants or persons entitled to participation, as such;
   d. the corporate tax as well as any form of tax imposed outside the Realm according to profit, if an arrangement for the purpose of preventing double taxation is applicable to the taxpayer;
   e. dividend tax and games of chance tax imposed because of profits earned.

2. Affiliated companies, as defined in Article 23(d) of the Corporate Income Tax Act, are companies which own or have owned in the last five years, directly or indirectly, at least one third of the nominal paid-in capital in the other company.

ECONOMIC PROBLEM

Often tax specialists forget that transfer pricing is essentially an economic question. In establishing the proper method of intercompany pricing, the multinational enterprise has to take into account all possible economic factors, of which tax liability is but one of many.

Consequently, if the multinational enterprise is able to establish that its method of intercompany pricing is based on sound economic principles, and that, regardless of the outcome, the method is applied throughout the enterprise, both in dealings with associated enterprises and in dealings with unrelated parties, it will be difficult for the Dutch Revenue to successfully challenge the transfer pricing methodology of the multinational enterprise.

THE ARM'S LENGTH PRINCIPLE

Although the arm's length principle is a commonly accepted principle of Dutch tax law, there is no consensus of opinion as to its precise meaning or to the method of determining an arm's length price in any given case. Even the concept of affiliated companies lacks a clear definition. The most one can say is that the closer the relation between two companies, the more attention is given to their mutual transactions.

The Dutch Revenue has formally accepted the rules and recommendations of the OECD reports. The Dutch Law Courts also take into consideration the OECD rules and recommendations before making their decisions.

The Report of the OECD Committee on Fiscal Affairs of 1979, "Transfer Pricing and Multinational Enterprises", deals, in general, with the tax consequences of transactions between members of a multinational enterprise. That Report was followed up by the Report of 1984 dealing with three specific taxation issues in connection with transfer pricing and multinational enterprises, and by an EEC Directive on the exchange of information and mutual assistance in order to combat tax fraud, and avoid abusive transfer pricing.

These Reports have resulted in recommendations to the governments of the OECD Member States that their tax administrations take several factors into account when reviewing and, if necessary, adjusting transfer prices between associated enterprises for the purposes of determining taxable profits. These factors include the considerations and methods set out in the report of 1979 for arriving at arm's length prices when goods, technology, trademarks and services are provided or supplied or loans are granted between associated enterprises.

In making this recommendation, the OECD has recognized the fact that transactions between associated enterprises (i.e. between parent and subsidiary companies or companies under common control) may take place under conditions differing from those existing between independent enterprises. Whereas, for tax purposes, the prices charged in such transactions between associated enterprises (the intercompany transfer prices) should nevertheless be in conformity with those which would be charged between independent enterprises as provided in article 9(1) of the OECD Model Double Taxation Convention on Income and on Capital in the arm's length principle.

In order to determine precisely whether a particular transfer price conforms to the arm's length principle requires direct reference to prices in comparable transactions between enterprises independent of each other.

This method is frequently referred to as the "comparable uncontrolled price" method and is, in principle, the most appropriate and, in theory, the easiest method to use. However, in the daily practice of a multinational enterprise with numerous transactions between associated enterprises, the existence of a "comparable uncontrolled price" tends to be a myth because such evidence is rarely available, or is impracticable to collect, or there is an argument about whether the prices quoted are comparable or not.

The achievement of the OECD reports is that they recognize this fact and provide a number of guidelines for the establishment of other methods which may be used to obtain the theoretical arm's length price. The main broad methods of ascertaining arm's length prices in non-arm's length situations described in the 1979 OECD report are as follows:

(i) Adopting with any necessary modification the uncontrolled market price for the same or similar goods, or adopting or adapting the prices of the same or similar goods to independent third parties – the comparable uncontrolled price method.
(ii) Taking the price at which the goods are sold by the connected purchaser to independent customers and subtracting a mark-up to arrive at the arm's length price for the sale by the original vendor – the resale price method.
(iii) Taking the vendor's cost and adding an appropriate mark-up to arrive at the arm's length price for the sale by the original vendor and thus for the purchase by the reseller – the cost-plus method.
(iv) Any other method which is found to be acceptable.

As stated above, the price comparison method is often not practicable in the absence of comparable transactions with third parties. The cost-plus method or the resale price method both use standard profit margins to find the applicable price.

In practice this frequently leads to confusion as to what factors will determine the proper arm's length price. Therefore, it is felt both by taxpayers and many tax inspectors in the Netherlands, that these methods are, despite their objective appearance, rather arbitrary and subjective guidelines.

For this reason it seems that the Dutch authorities have no intention of introducing statutory provisions or general guidelines, similar to the Guiding Principles of the British Inland Revenue issued in 1981. It should, however, be noted that on 25 April 1985, the Dutch Ministry of Finance issued a Circular containing administrative guidelines with respect to the tax treatment of certain activities within multinational enterprises. The Circular provides guidelines on the allocation of central management costs, as well as guidelines on the taxation of support, preparatory and auxiliary activities.[3]

DUTCH PRACTICE

Dutch tax law grants the multinational enterprise full freedom in selecting the method of transfer pricing which it deems most appropriate for itself as a group or for its Dutch associated enterprise as an individual taxpayer. There are very few published court cases concerning disputes between the Dutch Revenue and a multinational enterprise about the method of intercompany transfer pricing applied by the multinational enterprise.

However, this fact should not be interpreted as an indication that the Dutch Revenue rarely opposes the intercompany transfer pricing method employed by the enterprise. It only proves that intercompany transfer pricing issues are usually settled by the taxpayer and the Revenue out of court.

The compromise is seldom the result of an application of one of the guidelines referred to above, but rather the result of bargaining.

In view of the enormous difficulties pertaining to the establishment of arm's length prices in specific cases, the Dutch tax authorities do not readily attempt, as a rule, to reallocate profits in a purely domestic context, i.e. between related companies resident in the Netherlands. There is an exception, however, where profits are shifted to an affiliated domestic loss company.

In dealing with transactions between resident and nonresident companies, the Dutch authorities tend to intervene when the foreign company is established in a *low* tax country. The Dutch authorities are also exhibiting an increasing interest in intercompany transactions, particularly when the companies involved are residents of *high* tax countries.

Remarkably enough, prices calculated by the head office and the foreign permanent establishment are, in practice, examined with even more scrutiny and are more often subject to criticism than are prices calculated between related companies.

Where transactions with companies in low tax countries are involved, the arm's length test is, in principle, fully applied. Unjustified benefits under cover of increased or decreased prices granted to foreign affiliated companies (whether they are parent, sister or even more remotely related companies) are reintegrated in the taxable income of the Dutch company. Unsupported expenses, fees or commissions are disregarded in computing taxable income.

The amount of the reallocated profit will be taxed at the ordinary tax rates and, subsequently, will be deemed to have been distributed – a so-called "constructive dividend". The constructive dividend will then be subject to the dividend withholding tax.

CASE LAW

As stated in the second paragraph of the arm's length principle, in general, the OECD reports may be used as guidelines for determining intercompany transfer prices acceptable to Dutch tax inspectors. However, two differences exist between the arm's length principle of the OECD and the Dutch interpretation of this principle.

Under Dutch tax law, the Revenue may only adjust intercompany transfer prices on the basis of the arm's length principle if the parent company is aware that the intercompany pricing is advantageous to its subsidiary or vice versa.

Furthermore, according to the OECD report, companies may be considered to be associated if one of them has the leadership of the other or supervises the other company. In Dutch law a similar concept does not exist.

The judgment of the tax authorities will depend, in large part, on the factual circumstances of each case. Consequently, just quoting some of the very rare decisions may not be very enlightening. However, to give a general idea about the reasoning applied by the Dutch courts, some recent cases which dealt with transactions between a Dutch company and an associated company located in a tax haven jurisdiction will be mentioned.

Court of The Hague, 13 June 1984, BNB 1986/13

An Agreement between affiliated enterprises whereby the extent of the work to be done is not determined in advance, and the enterprise which performs this work can count on a fixed income determined in advance, is equal to and has to be considered in the same way as the performance of work in labor production. Fixed income contracts for undefined work between affiliated companies are treated as labor contracts. In such cases it is not uncommon practice for the enterprise performing this kind of work to make a profit equal to a fixed percentage of the production costs. In the event that the principal runs the full risk concerning the duties performed by the associated enterprise, a profit margin for the associated enterprise of 1% of the costs is reasonable. The amount paid on top of this percentage is considered to be part of the profit of the principal.

Court of The Hague, 22 January 1982, BNB 1983/109

In this case, The Hague Court ruled that a commission of 7.5% of the purchase price for the associated pur-

3. Circular letter No. 084-2737, 25 April 1985, of the Under-Minister of Finance. See *European Taxation*, April 1986, page 103.

chasing enterprise was reasonable because the enterprise concerned did not have to maintain stock and did not require suppliers' credit. The amount in excess of the 7.5% was considered to be a hidden capital contribution by the parent company to its subsidiary (i.e. re-adjusted to the taxable income of the Dutch parent company).

Court of Amsterdam, 15 November 1985

A parent company, engaged in the trading of fish, established an Antillean subsidiary which acted as purchasing/selling center for many companies in the group, including two Dutch subsidiaries.

The Court ruled that the taxpayer is free to choose any convenient corporate structure and that this has to be accepted by the tax inspector. The Court considered application of the arm's length doctrine, the only relevant issue, and it found that there was no evidence that prices realized by the Antillean subsidiary did not meet that criterion.

Court of The Hague, 10 May 1984, BNB 1986/8

Taxpayer leases motion pictures, of which the rights are obtained from its U.S. parent company, and paid from the rentals a certain percentage to this U.S. company. The Court ruled that the taxpayer had made it sufficiently clear that, in case of contracting with unrelated motion picture lease offices, the percentage would not be lower than the one paid.

ADVANCE RULINGS

When a resident company wishes to ascertain whether the proposed conditions of intercompany transactions are acceptable to the Dutch tax authorities, it may apply for an advance tax ruling. In practice, tax rulings are frequently requested and obtained with respect to the taxable profit of Dutch companies which are part of an international group and act as finance companies, patent holding companies, holding companies or service companies.

Rulings are legally binding agreements between the taxpayer and the tax inspector. These rulings may be granted for a period of three to five years. They may be renewed, unless the circumstances have changed materially.

MEANS OF AVOIDING DOUBLE TAXATION

If, as a result of the decision of a Dutch Tax Court or a compromise reached between the taxpayer and the Revenue concerning the adjustment of intercompany transfer prices, the taxable income of the Dutch taxpayer is (nationally) increased, the enterprise may attempt to avoid the resulting double taxation through the so-called mutual agreement procedure ("amicable procedure") provided for in most modern tax treaties. In theory, double taxation occurs when another associated enterprise of the same multinational enterprise already recorded the same income and paid tax on it.

Under the mutual agreement procedure, if the companies involved in the dispute are situated in countries which have concluded a tax treaty with the Netherlands, the victim may request the tax administration to attempt to negotiate a settlement with the competent authorities of the other State(s) to avoid double taxation.

Where no tax treaty is in effect, double taxation seems inevitable.

Even where a tax treaty exists, however, the amicable procedure between competent tax authorities is seldom used and the limitations of such procedures are well known. Sometimes the time limits for starting the process have expired by the time the reallocation action is brought to the knowledge of the resident taxpayer. More importantly, the amicable procedure, which is a troublesome and time consuming affair, does not oblige the competent authorities of the countries involved to reach a compromise in order to avoid double taxation.

CONCLUSION

Transfer pricing remains an undeveloped area of the law in the Netherlands. Most cases are handled independently and are not of universal application. Advance tax rulings are frequently requested and obtained. Intercompany transfer pricing issues are usually settled by the taxpayer and the Revenue out of Court. The Dutch Revenue has formally accepted the rules and recommendations of the OECD reports.

JAPAN:

The New Intercompany Pricing Rules

By Dean A. Yoost, Takashi Watanabe and Nancy Fox-Moore

The Japanese Diet passed legislation in March of 1986 and Japan joined with the majority of the international trading powers and adopted intercompany transfer pricing rules applicable to cross-border transactions between related parties. The new rules apply to corporations whose accounting year begins on or after 1 April 1986.

Although the law was fashioned after existing laws, the Japanese law is open to interpretation by the Japanese National Tax Administration ("NTA"). It is actually quite premature to speculate as to how the law will be enforced by the NTA as the provisions are not specific and the interpretative rules have not been issued. This article therefore only seeks to guide one through the law and highlight the general principles of the law.

In essence, the law provides that transactions between affiliated juridical persons must be conducted at an arm's length price. If transactions are not conducted at an arm's length price, the NTA has the authority to restructure the transaction for tax purposes as if it had been.

TYPES OF TRANSACTIONS GOVERNED BY THE LAW

The new law applies to international transactions involving the sale or purchase of tangible personal property and "other transactions". It is believed that the NTA will seek to enforce the law for any and all types of international transactions and has purposely not included any limitations. There is growing concern as to how the NTA will apply this law to industries which traditionally have not been affected by intercompany transfer pricing laws (e.g. financial services, securities industry, etc.).

Domestic transactions are not considered within the scope of the new law.

PERSONS TO WHOM THE LAW WILL APPLY

Transactions between a juridical person and a foreign affiliated juridical person fall within the purview of the law.

Juridical persons

Juridical persons include corporations, corporations in the public interest such as incorporated associations or foundations, and cooperative associations such as agricultural cooperative associations or small enterprise cooperative associations. It does not include partnerships or individuals.

Foreign juridical persons

A foreign juridical person is a juridical entity which is established under the laws of a foreign country and does not have its main office in Japan.

Affiliated persons

To determine if two juridical persons are affiliated, the persons must meet one of the following thresholds:

(a) There is at least 50% ownership of one juridical person by the other. The 50% test will be satisfied if the person, directly or indirectly, owns 50% or more of the total number of shares (voting and non-voting) in the other person.
(b) A "special relationship" must exist between the two juridical persons. The definition of "special relationship" is critical in determining which transactions fall within the purview of the law where the 50% stock ownership test is not met. In fact, a "special relationship" may exist without any stock ownership at all in the other person.

A "special relationship" will exist in the following cases:

(1) 50% or more of the officers of the company are or were employees or officers of the other company.
(2) The representative director of the company is or was an employee or officer of the other company.
(3) A substantial percentage of a company's operating transactions are with the second company.
(4) A substantial percentage of the company's outstanding loans which are necessary to the company's operations have been borrowed from or guaranteed by the second company.

The NTA is anticipated to issue a Circular which will further define the time limits for the special relationship test and definitions as to what will be considered a substantial percentage.

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TRANSACTIONS CONDUCTED AT AN ARM'S LENGTH PRICE

The law is straightforward and clear concerning transactions involving the sale or purchase of inventory. Basically, it provides that the arm's length price is to be determined under one of three methods – the comparable uncontrolled price method ("CUP"), the resale price method, or the cost plus method. There is no priority in the application of these three methods. If none of these three methods can be utilized, a reasonable method may be applied. The three methods are defined in the law as follows:

(a) Comparable uncontrolled price method ("CUP") – The CUP method is the application of the price which would have been paid between a buyer and a seller who are unrelated, where the sale or purchase of inventory is the same type of inventory as the inventory in the foreign affiliated transaction and where the circumstances are similar.

(b) Resale price method – Under the resale price method, a "normal profit margin" is deducted from the resale price to an unrelated party of merchandise similar to that which is sold or purchased in the foreign affiliated transaction.

(c) Cost plus method – The cost plus method requires a normal mark-up to be added to the purchasing, manufacturing or other costs of the inventory purchased or sold.

However, the law becomes vague in its application to transactions other than those involving the sale or purchase of inventory. Under the law, all other transactions must be transacted at an arm's length price. The arm's length price may be determined under the methods discussed above or another method can be used if these methods are not feasible. The law provides no detail or clue as to what the NTA will agree is a reasonable or similar method. An Enforcement Order, which was issued in this regard, shed very little light on the NTA's expectations. It is generally believed that the NTA will look to U.S. precedent in this area to determine what is a reasonable method.

ENFORCEMENT AND INFORMATION COLLECTION

The new law provides three separate provisions regarding information collection: the presumption provision; provision on foreign-based information; and the provision on information returns. These provisions have been included to aid in the collection of data and to insure smooth audits.

Presumption provision

Briefly, when the necessary documents are not provided by a taxpayer, the NTA is authorized to use the gross margin ration of other corporations engaged in the same type of business activity to calculate the arm's length price. The price calculated is presumed valid and the burden of proof is substantially shifted to the taxpayer to prove otherwise.

Provision on foreign-based information

This provision authorizes the NTA to require the relevant corporation to endeavor to obtain foreign-based information. The NTA has stated that if a corporation is not able to obtain the information, they will rely on information exchange programs between the other countries' tax authorities.

Provision on information returns

Corporations are now required to file a periodic information return on their foreign affiliated corporation(s) and the current state of their transactions.

CONCLUSION

The new law provides the NTA with a framework and the authority to police intercompany transfer pricing transactions. As the law is in its developmental stages, the NTA is in a pivotal position to determine the overall focus and effect the law will have on international transactions.

AUSTRALIA:

Foreign Tax Credits

By Don Orrock

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Until 30 June 1987, income derived by an Australian resident from a source in a foreign country and taxed in that country will be exempt from Australian income tax. The only exceptions are all foreign-source dividends and interest and royalties derived in countries with which Australia has a double tax treaty. Australian residents deriving these forms of foreign-source income are able to claim a credit against their Australian tax for the foreign tax paid.

As from 1 July 1987 a new system will operate, substituting a credit for foreign tax paid on all foreign-source income. Foreign-source income derived by an Australian resident after 1 July 1987 (or if a substituted accounting period applies, the first day of the period substituted for the year commencing 1 July 1987) will no longer be exempt from Australian income tax. To qualify for the credit the foreign tax must actually have been paid.

A foreign tax credit will be allowed for foreign taxes on income, profits or gains (whether income or capital), in respect of foreign-source dividends between related companies, taxes on the underlying company profits, or taxes subject to a double tax treaty. These taxes may be federal, state or local. Unitary tax or similar taxes are specifically excluded from the foreign tax credit system.

A foreign tax credit will be allowed to a taxpayer in respect of foreign income where the foreign tax on that income was paid:

(i) by another person under an agreement with that person or under the law relating to that tax;
(ii) by a trust estate in which the taxpayer is a beneficiary;
(iii) by a partnership in which the taxpayer is a partner;
(iv) by deduction (i.e. withholding tax); or
(v) by the taxpayer's spouse.

A credit is also allowed to the beneficiary of a trust estate where the beneficiary's foreign-source income entitlement in that trust estate was derived from another amount of income (called the primary amount) which was subject to foreign tax. Where the amount of income the beneficiary receives is reduced because of the payment of foreign tax on the primary amount, the beneficiary is entitled to a credit for that foreign tax.

Australian tax is imposed on the gross amount of any foreign income derived, including any foreign taxes paid on that income. Where foreign taxes have been paid on underlying foreign related company income in respect of foreign dividends, the amount of dividend subject to Australian tax is grossed up by the amount of the foreign taxes paid on the underlying related company income.

The foreign source of income will be traceable through a partnership or trust estate to deem a partner or beneficiary deriving that income to have derived it from that foreign source.

Foreign income derived by an Australian resident from carrying on a foreign business must be converted to Australian dollars at the average exchange rate applicable during the time the income was derived. Foreign taxes must be converted at the exchange rate applicable at the time the tax is paid. Other foreign income (and foreign taxes thereon) must be converted at the exchange rate on the day on which that income is remitted to Australia, or if not remitted, at the end of the year.

INCOME FROM OVERSEAS EMPLOYMENT

An exemption from Australian tax will continue to apply for foreign earnings of persons engaged in foreign service for a continuous period of not less than 365 days. A part exemption will apply to foreign earnings of a person on foreign service for a continuous period of less than 365 days but not less than 91 days.

The foreign earnings must be subject to tax in the country of source and that foreign tax must be paid or the Commissioner must be satisfied it will be paid.

DIVIDENDS AND CLAIMS FOR FOREIGN UNDERLYING TAX

Foreign dividends received by a taxpayer are to be grossed up by the foreign taxes, including any withholding tax, paid in respect of such dividends. This grossed up amount will be included in the taxpayer's assessable income. A credit for the foreign taxes paid, including withholding tax, will be allowed as stated above.

Where an Australian company receives a foreign dividend from a *related* foreign company, under certain circumstances a foreign tax credit will be allowed in respect of foreign underlying taxes paid on the profits out of which the dividend was paid.

A foreign company is related to an Australian company where it meets the following tests:

(a) The Australian company has a voting interest in the foreign company of at least 10% of the voting shares of the foreign company; or
(b) The Australian company has at least 10% voting interest in a foreign company, which in turn has at least a 10% voting interest in another foreign company and the Australian company has, directly or indirectly, at least a 5% voting interest in those foreign companies, then all such foreign companies, regardless of in which tier of the chain they fall, will be related foreign companies.

For the purposes of foreign tax credits a company will be either an Australian company or a foreign company. An Australian company is a company that is a resident of Australia. A foreign company is a company that is not a resident of Australia.

The underlying tax in relation to a dividend paid by a company, means tax payable by the company on the profits out of which the dividend is paid.

Provided the dividend is paid by a foreign company or companies meeting specified tests as to their relationship to the Australian company a credit will be available for the underlying foreign tax paid in respect of those dividends.

The amount to be included in the company's assessable income, in respect of foreign dividends for which a credit is allowed for underlying foreign taxes paid, will be grossed up by the amount of those underlying foreign taxes.

INTEREST INCOME

Interest income constitutes a separate class of income and will be subject to special provisions in respect of the foreign tax credit system. Where a taxpayer derives foreign income which includes interest income and other income, the foreign tax credit provisions will

Example of credit for underlying foreign tax on foreign-source dividends

100% owned foreign company subsidiary of an Australian company receives a dividend from the foreign subsidiary on the following basis:

Foreign company net taxable profit		$ 2,000
Foreign tax thereon (at 30%)		600
Available distributable profit		1,400
Dividend distributed to Australian company		1,000
Foreign dividend withholding tax (at 15%)		150
		$ 850
Gross up for foreign dividend withholding tax paid		150
Gross up for underlying tax applying to dividend $(\frac{1,000}{1,400} \times 600) =$		429
Amount included in Australian assessable income		$ 1,429
Australian tax thereon (at 49%)		700
Foreign tax credits – withholding tax	$ 150	
– underlying tax	429	579
Australian tax payable		$ 121

apply separately in relation to those two classes of income.

Interest is broadly defined and includes a payment in the nature of interest in respect of:

(a) money lent, advances or deposits;
(b) credit given; or
(c) any form of debt or liability.

Interest does not include:

(a) interest derived by the person from a transaction directly related to active conduct of a trade or business;
(b) interest derived by carrying on a banking business or some other business the income of which is principally derived from the lending of money; or
(c) interest derived by a company from a related company where the interest income did not exceed 10% of the total profits derived by the company during the year of income or the preceding year as applicable.

Where a foreign company derives net interest income amounting to a minimum of 10% of its total profits, it is deemed to have an interest pool. Dividends paid by that foreign company, to an amount not exceeding the amount of the interest pool, will be deemed to be interest income derived by the Australian company receiving the dividends.

CALCULATION OF FOREIGN TAX CREDIT

The foreign tax credit system will be operated on an aggregate basis as opposed to a per country basis. This results in the total amount of foreign tax paid in respect of foreign income classes derived in all foreign countries being aggregated to ascertain whether a taxpayer is entitled to a credit against Australian tax payable.

The exceptions to this rule of aggregation are in respect to a claim for foreign-source losses and claims for credit for foreign taxes transferred within group companies.

Where:

(a) the assessable income of a resident taxpayer includes foreign income; and
(b) the taxpayer has paid foreign tax in respect of that foreign income for which he was personally liable (as mentioned above).

The taxpayer is entitled to a credit equal to the lesser of:

(a) the amount of that foreign tax, reduced in accordance with any credit, rebate, remission or deduction available to the taxpayer under the law relating to that tax; or
(b) the amount of the Australian tax payable in respect of the foreign income (ascertained by applying the average rate of Australian tax to the adjusted net foreign income reduced by any rebate relating exclusively to the foreign income).

FOREIGN-SOURCE LOSSES AND EXCESS CREDITS

Foreign-source losses will not be available for deduction against Australian-source income.

Foreign-source losses incurred during the 7 years preceding the commencement of foreign tax credits and foreign-source losses in future years will be available to be set off against foreign-source income of the same branch or activity in that foreign country.

Losses in relation to interest may only be allowed against future interest income from the same source.

Australian losses may be carried forward for deduction from future Australian profits or, by election of the taxpayer, may be deducted from foreign-source income in the year the loss is incurred.

It is important to note that foreign-source losses are only deductible against foreign income from the same source. A foreign source is defined as:

(a) a business carried on by the taxpayer at or through a permanent establishment, in a foreign country; or
(b) any other business, commercial or investment activity carried on the taxpayer in a foreign country.

Therefore a taxpayer is denied a deduction for foreign losses against foreign income from another country; another business, commercial or investment activity carried on in the same foreign country; or another permanent establishment in the same foreign country.

This will apply to both carried forward and current year foreign losses.

Excess unutilised foreign tax credits are not available to be carried forward to future income years. These excess credits may only be utilised in the year incurred, by transfer to a group company. The grouping tests for companies are the same as those under the group loss provisions of the Income Tax Assessment Act. Group companies are basically wholly owned parent subsidiary and fellow subsidiary relationships.

A company with excess foreign tax credits may transfer those excess credits to another company grouped with it by giving written notice to the Commissioner of Taxation.

In order for the group company to be able to utilise the transferred foreign tax credit, the group company must derive foreign income of the same class and be liable for and have paid foreign taxes in respect of that foreign income. Where the group company is exempt from foreign tax in respect of foreign income (e.g. by virtue of double tax treaty permanent establishment provision) that income will not be available to allow a credit for any foreign tax credit transferred from a group company.

TAX SPARING

It has been recognised that certain foreign countries, in order to encourage investment in their country, allow income derived therein by foreign investors to be exempt from tax or the tax thereon reduced. In order to preserve this incentive a tax sparing provision has been included in the foreign tax provisions.

The effect is to allow as a credit, tax deliberately foregone by a foreign taxing authority. The foreign tax credit provisions deem the foreign tax foregone to have been paid by the taxpayer. The relevant foreign income is grossed up by the amount of deemed foreign tax paid and the grossed up amount is included in the taxpayer's assessable income.

INTERACTION WITH DOUBLE TAX TREATIES

Problems may exist in obtaining tax credits in Australia for underlying foreign taxes paid in respect of dividends received from foreign companies resident in certain countries with which Australia has double tax treaties. For example, the Australian/Italian Convention, in the Protocol thereto, states that a credit for foreign taxes paid in respect of dividends "shall not" include tax paid in respect of the profits out of which the dividend is paid (the underlying tax).

Although the Australian legislation allows a credit in respect of this underlying tax, the provisions of a double tax treaty specifically prevail over Australian taxation provisions. Care will be required to ensure that in deriving foreign-source income from certain countries, the double tax treaty with that country does not limit the ability to claim a full foreign tax credit.

CONCLUSIONS

1. The inability to offset foreign tax losses from one

source against foreign income of another source may require consideration to be given to the manner in which foreign business is conducted. Where foreign business is conducted through more than one permanent establishment in the same country consideration may be given to conducting all business through one permanent establishment.

2. A claim for a credit for part of the tax paid in a foreign country may be permanently lost if a deduction is not available in the foreign country on the same basis on which it is available for Australian tax purposes.
3. The ability to transfer excess foreign tax credits to other group companies will improve the ability to more fully utilise all foreign tax credits. Therefore review may be required of the group shareholding structures.
4. Derivation of more than one class of foreign income from several sources may result in payment of Australian tax on foreign income while foreign tax credits are unutilised.
5. Records will have to be maintained when receiving foreign-source dividends and distributions from partnerships and trusts to permit calculation of any underlying foreign taxes or foreign taxes paid by the partnership or trustee of the trust estate.
6. Details of foreign dividends received establishing that such dividends were not paid from an "interest pool" will need to be maintained.
7. It is possible for a company or an individual to be a dual resident of Australia and another country at the same time for taxation purposes. Even where a double tax treaty exists between the two countries, it does not always provide a basis for determining that the company or individual is only a resident of one of the countries (e.g. Australia/U.S. Double Tax Treaty in relation to companies). A company may be, for example, a dual resident where it is incorporated in Australia, but managed and controlled in the U.S.A. If the company derived income from a source, in say Argentina, it will be subject to tax in Australia and the U.S.A. as both countries tax their residents on their worldwide income.

   A problem may arise in obtaining a foreign tax credit against the Australian tax for the U.S. tax paid in respect of this income by virtue of the fact that no tax credit is allowed for "unitary tax". The definition of "unitary tax" means "tax imposed by a law of a foreign country, being a law which, for the purposes of taxing income, profits or gains of a company derived from sources within that country, takes into account, or is entitled to take into account, income losses, outgoings or assets of the company . . . derived, incurred or situated outside that country . . .". This would appear to include the U.S. tax payable in the situation above. The Argentine tax would be allowed as a credit. Urgent planning would be required to sidestep this problem.
8. Australian companies with New Zealand operations face special issues in seeking to fully utilise the higher New Zealand taxes as credits in Australia. This may require a change in the existing corporate structure or financing arrangements.
9. Possible changes to corporate structures become more likely in the case of Australian companies with operations in South East Asia and Oceania. The mix of high and low tax rates in these regions makes the choice of corporate vehicle and its location critical to the maximising of foreign tax credits.
10. Australian companies with extensive international operations may find it advantageous to move offshore to a low tax country leaving the Australian operations as a subsidiary of the new international structure.
11. Operations in foreign low tax rate countries could well be conducted through a subsidiary in that country to defer Australian tax liability on the foreign profits.
12. Foreign companies using Australia as a base for their South East Asian activities should reconsider the advisability of using the Australian company as a holding company for investments in subsidiaries in that area.

ERRATUM

In the article "Taxation of Rental Property Income in Burkina Faso", by Mr. Lawrence Rupley, published in the July 1986 issue, the first sentence of paragraph 2, page 299, beginning, "For 1985, . . ." should state:

"For 1985, the effective tax rate on rental income was 100%: Burkina residential tenants were allowed to live rent-free for the year, while all commercial or other organization tenants were required to pay all rents directly to the Government rather than to the owners of the rental properties."

THAILAND:

Transfer Pricing Provisions, Rulings and Case Law

By Montri Hongskrailers and K.S. Jap

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A. INTRODUCTION

The aim of this article is to present the arm's length principle and inter-company pricing provisions, rulings and case law in Thailand.

With respect to transfer pricing etc. the following was stated:[1]

1. The arm's length principle and inter-company pricing

The arm's length rule specifies that all transactions between the headquarters and an affiliate or among the affiliates themselves should be done as if all these entities were distinct and separate enterprises. All pricing and other treatment should be charged and documented in the same way as it would be charged and documented to a distinct and separate enterprise engaging in the same or similar activities under the same or similar conditions and dealing wholly independently of each other.

Transfer pricing is a means by which profits can be siphoned out of Thailand without paying tax. By transferring the profits to the headquarters in the form of inflated prices on goods sold to an affiliate in Thailand, the company reduces the profits of the branch or subsidiary or other affiliate located in Thailand and avoids the profit tax. This also transfers profits to the headquarters, without paying taxes on remitted profits. This practice is widespread among foreign multinational companies in Thailand.

Thai tax law has a provision to guard against this practice. Section 65bis(7) of the Revenue Code specifies that the assessment officer has the power to establish cost prices of imported goods by comparison with the cost price of the goods of the same category and type which are delivered to another country. It is very difficult, however, to put this power into practice since cost prices in the world market are either non-existent or not easily identifiable.

In some cases, the affiliate exports goods to the parent company at a price lower than the market price so that more profit may be attributed to the parent company and less profit is left for the branch or subsidiary. This also avoids tax in the host country. There is also a provision to prevent this practice. Section 65bis(4) of the Revenue Code empowers the assessment officer to establish prices at the market value on the date of transfer if he believes that goods are transferred, without justifiable grounds, at a price lower than the market value.

2. Transfer of inventory between parent and subsidiary companies

Another common practice of multinational companies

1. In 37 *Bulletin for International Fiscal Documentation* 8 (1983) at 361-364, a Working Paper was reproduced which was presented at the 12th Meeting of the Study Group on Asian Tax Administration and Research (SGATAR), 7-12 June 1982 in Kuala Lumpur, Malaysia. The subject of the Working Paper is entitled: Recent Development and Problems Relating to the Taxation of Multinational Companies in Thailand. Specific topics covered in this Working Paper were further elaborated in: "Thailand: Loss Companies", 38 *Bulletin for International Fiscal Documentation* (1984) at 249-250. "Thailand: Taxation of Royalties, License Fees, Etc., Paid to Non-Resident Licensors", 38 *Bulletin for International Fiscal Documentation* (1984) at 501-503.

(MNCs) in avoiding taxes is to transfer inventory from the subsidiary to the parent company without compensation or charges. This can be done under the disguise of sending "samples" or goods for advertising purposes. In effect, this is a transfer of profit from the subsidiary to the headquarter company. Other than inventory, the objects of transfer could be in the form of services rendered without charge or money lent without interest. Thai tax law has a provision to prevent this practice, Section 65bis(4). Therein it states that in the case where, without justifiable grounds, property is transferred, a service is rendered, or money is lent without any compensation, service charge or interest, or with compensation, service charge or interest in an amount lower than the market value, the assessment officer has the power to assess the compensation, service charge or interest at the market value on the date of transfer, rendering of the service or lending.

3. Banking and transfer of funds across international boundaries – "Garnering" effect

Another way to avoid paying tax in a high tax country is to gather funds in the form of a loan to the subsidiary in the country where the tax is high. Interest would be charged to the subsidiary, thereby reducing the taxable profit of the subsidiary. However, MNCs must consider the country's withholding tax on interst remitted abroad. In the case of Thailand, interest paid to a foreign company is subject to a 25% tax rate. Thus it is worthwhile to keep funds in the form of loans to the subsidiary in Thailand since corporate income tax in Thailand is 40% on profit and 25% on profit remitted abroad. For example, if the interest is ฿ 1,000,000, tax on the interest is ฿ 250,000 but the profit of the subsidiary would be reduced by ฿ 1,000,000 and tax on profit would be reduced by ฿ 400,000 plus a reduction of tax on remitted profit of ฿ 150,000 (25% × 600,000). Therefore, the net gain in tax is ฿ 300,000.

Example:

Profit remitted as interest

profit	1,000,000
25% withholding tax	250,000
profit remitted	750,000

Profit remitted as dividends

profit	1,000,000
40% corporate tax	400,000
profit remitted	600,000
25% withholding tax	150,000
profit remitted	450,000

However, this may only be done in the case where the MNCs have subsidiaries in Thailand, not when a branch exises. This is because the headquarters and the branch are considered the same company by the laws of Thailand, thus, the company would be paying interest to itself. Therefore, deduction of the interest violates Section 65ter(10) of the Revenue Code which specifies that no consideration for the properties owned and used by the same company shall be allowed as expenses. Moreover, Section 65ter(11) specifically prohibits deduction of interest on capital, reserves or funds of the company.

4. Allocation of overhead expenses

Strictly speaking, under Thai tax laws, overhead expenses of the headquarters may not be deducted from profits of the branch. This is because Section 65ter(14) of the Revenue Code prohibits deduction of any expenses not exclusively expended for the purpose of business in Thailand. In auditing foreign MNCs, one quite often finds that profits are reduced for the purpose of avoiding taxes, by deducting expenses such as research and administration expenditures of the company headquarters from the profit of the branch. In this case not only is corporate income tax avoided, but also personal income tax. This is because expenses claimed as administration and research expenditures of the headquarters include salaries of executives working in a branch in Thailand. Since the salaries are not paid in Thailand, it is not possible to withhold taxes from these salaries.

The deduction of research and administration expenditures of the headquarters from the profits of the permanent establishments located in Thailand, however, is allowed if the company is incorporated in a country with which Thailand has signed an Agreement for the Avoidance of Double Taxation. This is because the Article concerning business profits in the Agreement usually allows these expenses as deductions, whether they are incurred in Thailand or elsewhere.

However, in the treatise above, the problems do not cover those affected by the payment or not of the Thai business tax (sales tax) as well as the rulings and Supreme Court decisions relating to the transfer pricing provisions under the corporate income tax, business tax and import duty laws. These topics will be elaborated later. However, the general calculation of the taxable income under the corporate income tax is set out first, before proceeding to the rulings and Supreme Court decisions under the corporate income tax, business tax and customs duty with respect to transfer pricing.

B. CORPORATE INCOME TAX

1. Calculation of taxable income

All companies and similar entitiēs (legal partnerships) registered under Thai law, or which are incorporated under a foreign law and carry on business in Thailand are subject to the corporate income tax governed by the Thai Revenue Code of 1938, as amended.

Resident companies of Thailand are subject to corporate income tax on their world-wide income. Section 65 of the Revenue Code provides that the income subject to corporate income tax shall be the net profits arising from or in consequence of the business carried on in an accounting period.

Non-resident companies of Thailand are subject to the corporate income tax levied on Thai source income only.

Section 66 of the Revenue Code provides that companies and partnerships established under foreign laws and carrying on a business (multinational companies) in various countries including Thailand are taxed on their net profits arising from or in consequence of their business carried on in Thailand.

The term "net profits arising from the business carried on in Thailand" means, the net profits arising from the business activities which a taxpayer derives directly from profit-seeking. The term "net profits arising in consequence of the business carried on in Thailand" applies to profits not arising directly from the primary business activity of the company, but purely from sideline activities not related to the business of the company.

Where income will be regarded as profits arising in consequence of the business of the company is determined by case law. In the Supreme Court decision No. 456-457/2509, it was ruled that, where a company owned land and buildings and later sold these for a profit, the company is required to include such profit in computing its corporate income tax amount. This is because the original purchase of the land and buildings was a business activity within the objectives of the company and, thus, when they were sold, and profits were realized, the gain is to be regarded as profits arising in consequence of the business of the company.

In another Supreme Court decision No. 1274/2497 it was ruled that a foreign company which had a branch carrying on mining operations in Thailand, receiving interest on bonds from abroad in accordance with the objective of the company, was not required to pay corporate income tax on that interest. Such income was not considered profits arising from or in consequence of the business carried on in Thailand.

The definition of carrying on a business in Thailand is very broad, and includes the following:

> If a de jure company or partnership incorporated under foreign law has an employee, representative or intermediary in Thailand for carrying on its business and thereby derives income or gains in Thailand, such de jure company or partnership shall be deemed to be carrying on a business in Thailand, and such employee, representative or intermediary, whether a natural or legal person, shall, insofar as the said income or gains are concerned, be deemed to be the agent of the said de jure company or partnership and shall have the duty and liability to file a return and pay corporate income tax (Section 76 bis).

Consequently, corporate income tax may be levied on either the net profits basis or the gross receipt basis.

2. Net profits versus gross receipts basis

The corporate income tax is imposed on the net profits of the business derived during the taxable calendar year or fiscal year on the accrual basis as of 1 January 1985. In determining the net profits, usual business expenses and depreciation allowances are allowed as deductions.

An income tax return must be filed within 150 days after the end of the taxpayer's accounting year. Any fiscal year may be selected in lieu of a calendar year.

The corporate income tax is imposed on the gross receipts or gross sales instead of net profits in the following cases:
(i) the carrying on of a business of international transportation of goods and persons (Section 67); and
(ii) any de jure company or partnership failing to file a return, or failing to keep the accounts required by the Thai Revenue Code, or failing to produce accounts required by the assessment officer (Section 71).

In the case of a business for international transportation, the taxable profit is 3% of the gross receipts. In the latter case (ii), the taxable profit is computed at the rate of 5% on the aggregate of either the gross receipts or the gross sales.

Effective as of 7 April 1986, the Revenue Department issued Instruction PAW No. 13/2529 (1986) requiring a company or legal partnership incorporated under foreign law and a) carrying on a business in Thailand, b) carrying on a business in various countries including Thailand, or c) deemed to be carrying on a business in Thailand because an employee, agent or representative is in Thailand carrying on a business and thereby earning income or profit in Thailand (hereinafter referred to as "said company"), will pay corporate income tax on the net profits basis and not on a 5% of gross receipts basis as previously practised in some cases under (ii) above.

The details of the Revenue Department Instruction No. PAW 13/2529, dated 7 April 1986, re: Payment of income tax by a company or legal partnership incorporated under Thai law or under foreign law and carrying on business in Thailand under Sections 66 and 76bis of the Revenue Code of 1938, as amended, shall be handled as hereinafter set forth:

> a. The said Company must pay corporate income tax from the net profit and must file a tax return within 150 days from the last day of its accounting period together with a balance sheet, business account, and a profit and loss statement certified by an auditor.
>
> b. The net profit on which to pay corporate income tax shall be calculated by including the income arising from or in consequence of their business carried on in Thailand during the accounting period less the expenses not disallowed under Section 65 ter(14) of the Revenue Code.
>
> Any payment made by a branch office in Thailand to its head office or another branch office in another foreign country as compensation for assistance or services rendered to the business of a branch office in Thailand, in order to have these charges treated as expenses (within the meaning of the Revenue Code) for purposes of calculating net profits, they must provide clear evidence that said payments were made. Clear evidence would be records showing that:

1) the assistance or services were rendered in relation to the business of the branch office in Thailand;
2) the results of research and development were utilized by the Thai branch office;
3) the expenses have not already been deducted as expenses by the head office or another branch office in computation of their net profit;
4) expenses shared by the Thai branch office are determined based by means of generally accepted accounting principles applied similarly and consistently to a branch office in another country.

All the expense payments and accounting methods employed must be certified by the foreign competent authority or person appointed by the Thai Revenue Department.

Expenses not considered to be deductible by the branch office in Thailand are: the exclusive expenses made by the head office or another foreign branch office in connection with e.g. office rents, water and electricity, stationery, sundries, depreciation and depletion of materials and tools (Departmental Instruction No. PAW 14/2529, dated 30 June 1986).

c. Said Company can file corporate tax returns and pay tax on 5% of the gross receipt only if the Director-General of the Revenue Department considers that said Company has proved its inability to otherwise ascertain net profits and allows or orders said Company to file the tax return in a form to be prescribed by the Director-General.

d. In case said Company filed a return and paid corporate income tax on gross receipts before receiving approval of the Director-General, as mentioned in No. 3 above, by using or modifying the form prescribed by the Director-General for other returns, it shall be deemed that said Company failed to file the corporate income tax return in the form prescribed by the Director-General.

e. In case said Company filed the return and paid corporate income tax, as mentioned in No. 4, above, the Assessment Officer shall assess tax in accordance with the rules mentioned in Nos. 1 and 2, above. If said Company has no evidence to prove its expenses, said Company shall be deemed to have the following expenses:
1. In case said Company engaged in a hire-of-work business, the standard deduction is 70% of the gross income.
2. In case said Company engaged in a trading business, the standard deduction is 80% of the gross income.

f. Any regulations, orders, rulings or practices contrary to Instruction PAW 13/1986 of 7 April 1986 are no longer in force.

C. ARM'S LENGTH TRANSACTION

1. On corporate income tax provisions

Section 65bis(4) Thai Revenue Code 1938, as amended, provides that, in the case where proprerty is transferred, services are rendered or money is lent without justifiable grounds and for compensation, or for compensation less than the market price, the assessment officer is authorized to assess the value of such asset transferred, service rendered or money lent, on the basis of the market value prevailing on the date of transfer, rendering of service or granting of the loan (effective as from 1 January 1979 by Emergency Decree Amending Act (No. 5) 1978).

Section 65bis(7) of the Revenue Code provides that the cost price of imported goods may be determined by the assessment officer upon comparison with goods of a similar nature and kind imported by other countries.

a. Rulings

The Revenue Department has issued the following rulings related to Section 65bis(4).

(i) *Ruling Gor. Kor. 0804/23574 dated 23 April 1979*

The company receives interest from a loan granted to its affiliated companies within a group of companies as well as interest from money deposited with the commercial bank. Both payments are deemed to be income from the company's direct business and it shall be added to any other income of the company for purposes of calculating the corporate income tax in accordance with Section 65 of the Revenue Code.

If the company's objective was also to grant loans generally and to companies in its group specifically it shall be deemed to be a business matter and it shall be treated as those companies regularly acting as a commercial bank.

Consequently, the interest from the loan shall be subject to the business tax in business category No. 12 of the Business Tax Schedule. However, the interest received from the money deposited with the commercial bank shall not be deemed to be income from business regularly conducted and similar to that of a commercial bank because the company of the group receiving the loan did not intend to carry on a business similar to that of a bank. As a result, no business tax was payable on the interest from the deposits.

(ii) *Ruling Gor. Kor. 0804/13499 dated 13 July 1979*

The company intends to rent a machine for five years for his clients. The rent is about the price of the machine plus 15% interest per annum. When the rental contract expires, the company will have received the rent which is equal to the price of the machine plus its profits. The company wants to sell the machine at less than the market price because the company has already received sufficient profit from this machine. Issue: is the sales price of this machine less than the market price? Is it subject to change under Section 65bis(4) of the Revenue Code?

The ruling stated that the company had not transferred the machine at less than the market price according to Section 65bis(4) of the Revenue Code. It is believed that the company can sell the machine according to the market price based upon the condition of the machine at the date of the transfer, notwithstanding the fact that the company received profit in the form of rent from the machine, plus interest.

(iii) *Ruling Gor. Kor. 0804/22599 dated 8 November 1979*

The company produces goods. The goods produced are of shoddy quality. The company decides to sell the processed goods at less than the market price. The company may do so because of the evidence of the circumstances. If the company wants to destroy the processed goods, the company may do so, taking into account the generally accepted accounting principles.

In both cases, the attitude is not contrary to Section 65bis(4) of the Revenue Code.

(iv) *Ruling Gor. Kor. 0804/8896 dated 22 May 1980*

The company wants to lease a machine to a limited partnership for 5 years. The price is 2 million Baht. The rent is fixed at 52,988 Baht per month, calculated at the price of the machine divided by 60, plus the operating profit based on the interest rate of 20% per annum. The lease contract includes the option to purchase the machine at a lower price than the book value which is 10,000 Baht. This price might be higher or lower than the market price prevailing on the date the sale is made. If the machine is sold to the lessee at the price of 10,000 Baht, whereas the market price at that time is 200,000 Baht, the transfer is deemed to be at less than the market price on the date the transfer was made and assessment in accordance with Section 65bis(4) of the Revenue Code shall occur.

(v) *Ruling Gor. Kor. 0802/13409 dated 25 September 1984*

A Thai company and a foreign company are in a joint venture to construct a project for the Department of Public Works. After the project was completed, the joint venture suffered a loss and was in debt with the financing bank. As a result, the joint venture had to borrow money from their partners without interest. The question was, is the loan from the partners without interest in compliance with Section 65bis(4) of the Revenue Code or not.

The Revenue Department ruled that the said loan is not contrary to Section 65bis(4) of the Revenue Code.

There is no ruling on Section 65bis(7) of the Revenue Code.

b. Supreme Court decisions

There are no Supreme Court decision on Section 65bis(4) and (7) of the Revenue Code.

c. Business tax

The business tax is governed by Chapter IV of the Thai Revenue Code of 1938, as amended, and its implementing regulations.

The business tax is a gross receipt turnover tax imposed on various categories of business listed in the Business Tax Schedule of the Revenue Code. The business tax is collected from manufacturers, importers and exporters as well as some traders (e.g. sellers of books, documents or printed materials; gold, diamonds, secondhand articles), while retailers are exempt. In addition, business tax is collected from the sale of securities, services rendered (contractors, advertisers, warehousing, hotel, restaurants, letting of property, transportation, banking, insurance, sale of immovable properties, brokerage businesses, photo studios, hair studios, steam bath parlors, etc.).

Studies have been conducted in Thailand to determine if the business tax should be replaced by a value added tax. The conclusion is that Thailand is not ready to introduce a value added tax, yet.

2. On business tax provisions

a. Assessment

Section 87bis(3) to (7) of the Revenue Code provides the authority for the assessment officer to assess a business tax. According to Section 87bis(3) to (7) the assessment officer may:

(i) fix the selling price of goods by comparison with a comparable market selling price, on the same or nearly the same day, for the same category or kind of goods or by comparison with the world market price;
(ii) fix the gross receipts from the letting of property by comparison with the rent which such property should normally obtain;
(iii) fix the gross receipts which a person engaged in business should have received in the event goods are sold for less than a reasonable selling price because there is control or a relationship with regard to capital or management between the person engaged in business and the purchases;
(iv) fix the price of property or services on the basis of the market price on the date of the transfer of property or rendering of the services, or if the consideration is less than the market price without sufficient reason;
(v) fix gross receipts upon consideration of the living condition or conduct of the person engaged in business, or business statistics of the person engaged in business himself or another person engaged in similar business, or upon consideration of other principles which reasonably indicate the gross receipts.

b. Rulings

There are no rulings on Section 87bis(3) to (7) of the Revenue Code.

c. Supreme Court decisions

(i) *Case 812/19*

The plaintiff is a sole distributor who has imported and assembled motorcars in Thailand. The foreign motorcar producer ordered the plaintiff to sell the motorcars to company A which was a former sole distributor.

The plaintiff must set the price of the motorcars, which are sold to company A, in accordance with the price which is set by the foreign motorcar producer. This price has been set close to the cost price and the wholesale price sold by the plaintiff, which in turn is quite different from the retail price of company A. What is the selling price of the motorcar to calculate the gross receipt for the business tax and the corporate income tax?

The assessment officer cannot take the price at which the motorcar is sold by company A to be the market price and cannot set the new selling price and gross receipts to increase the business tax and corporate income tax assessments.

(ii) *Case 211/25*
The transfer of any good by sale at a price substantially lower than the market price cannot be deemed to be the actual value of the good on the day of transfer. The assessment officer is empowered to fix the market price under the Revenue Code on business tax (Section 87bis(6)).

(iii) *Case 552/22*
If the plaintiff has filed an incorrect business return, the assessment officer may examine the plaintiff's gross receipts as data for use in fixing the actual and correct gross receipts according to Section 87bis(7) of the Revenue Code.

The law does not limit the officer to only the present year's gross receipts if the assessment officer judges that in any one year the person engaged in the business has filed an incorrect or mistaken business return which affects the amount of tax to be paid. The assessment officer is empowered to determine the gross receipts of the person engaged in business in that year.

(iv) *Case 798/21*
The assessment officer of the Revenue Department must apply the standard rules to a plaintiff company which has filed a business return using the percentage of sales method and compare this with the gross receipts of company "R" which is in the same area, having the same number of office rooms and the same number of officers and workers. The Revenue Department may send competent officials to check and verify the daily grand total gross receipts of "R" company at the beginning of a given month, in the middle and at the end of that month to ascertain the average computation and average monthly receipts to serve as a standard for establishing the company's gross receipts for use in the collection of retroactive taxes based on the gross receipts computation according to the procedures and principles laid down by the Revenue Department.

D. CUSTOMS DUTY

1. On customs duty provisions

Section 9 of the Customs Tariff Decree provides that, for goods subject to an ad valorem rate of duty, the Director-General of Customs may, from time to time, specify the average market value for any category of goods. Such value shall be deemed to be the value for assessment of duty on the specified category of goods instead of the actual market value as from the date of specification, until cancelled or modified by a subsequent specification.

The notice of the specification shall be made in the Government Gazette.

2. Ruling

There are no rulings on Section 9 of the Customs Tariff Decree.

3. Supreme Court Decision

(a) *Case 902/25*
The liability to pay customs duty on imported motorcars shall be incurred from the date on which the import took place. The calculation of the duty shall be in accordance with the nature and value of the motorcar and correspond to the customs duty at the time the plaintiff imported the motorcar. The value of the motorcar shall be calculated in accordance with the cash wholesale price of the motorcar not including the stamp duty.

E. TAXATION OF FOREIGN RESPRESENTATIVE OFFICES

On 30 June 1986, the Revenue Department issued the Departmental Announcement clarifying the corporate income tax and the business tax payable under the Revenue Code by representative offices doing business in Thailand. The following tax liability situations are set out.

1) In case a respresentative office is doing business procuring merchandise and exporting it under the instruction of its foreign head office, it shall be deemed that the exported merchandise is sold in Thailand at the market price prevailing on the export date and is so deemed as part of the merchandise price to be added as income for purposes of the corporate income tax for the accounting period in which the merchandise is exported in accordance with Section 70 ter of the Revenue Code, except in the case mentioned under 2) below.

2) The same as under 1) above, but the head office is located in a country with which Thailand has an effective comprehensive income tax treaty. The representative office shall not be deemed to be the permanent establishment of the head office (foreign company or legal partnership) and shall not be subject to the corporate income tax and business tax in Thailand.

3) A representative office renders various services to its head office, either by performing quality and

quantity control of merchandise purchased or rented for production purposes in Thailand, disseminating data or information over the new merchandise or service of the head office – including reporting on business developments in Thailand solely to its head office and not rendering such services to third parties. In addition, the representative office receives only support funds from the head office to cover the expenses of the representative office. The receipts or income so derived by the respresentative office from its head office shall not be deemed receipts or income for purposes of the corporate income tax or business tax.

4) The same as under 3) above, but the representative office renders services to third parties. No matter whether said services are paid for or not, it shall be deemed that the representative office is doing business in Thailand and must include all income or receipts derived from rendering all services when computing the net profits for purposes of the corporate income tax and the business tax. The taxes are levied at the rate of 3% of the gross receipts under Business Tax Category No. 4, hire-of-work, of the Business Tax Schedule. In addition, they must pay a municipal surcharge at the rate of 10% of the business tax amount payable.

5) The same as under 4) above, the representative office must apply for a business registration at the District Office or at the Area Revenue Office where said representative office is located, within 30 days from the date of commencing business operations. If it fails to register within the specified period of time it is subject to the business tax plus a penalty of 2 times the business tax accrued during the period not registered or Baht 200 per month, whichever is larger. In addition, it shall be subject to a surcharge of 1.5% per month, or a fraction of the business tax payable and may also be prosecuted under criminal statutes.

6) The same as under 1) and 3) above, but if the merchandise exported is subject to the business tax, the representative office must pay business tax under Category 1, Sale of Goods of the Business Tax Schedule. They must also pay a municipal surcharge at the rate of 10% of the business tax amount payable.

7) Any alien who works in a representative office doing business in Thailand, receiving a salary, paid either inside or outside Thailand, shall be subject to individual income tax under Section 41(1) of the Revenue Code. This tax shall be based on the time spent working in Thailand. The representative office paying the salary is required to withhold individual income tax at source and remit the tax amount to the Officer within 7 days from the date the salary was paid pursuant to Section 50(1) of the Revenue Code.

ISRAEL:

The Territorial Scope of Income Tax with Special Reference to the 1984 Amendment

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The 1984 amendment of s. 5(1) of the Israel Income Tax Ordinance, effective as of 1 July 1984,[1] reflects the growing tendency to depart from the concept of imposing the tax liability on the basis of the "source" of income. The purpose of this paper is to consider the development of the "source" method adopted by Israeli law for determining the territorial scope of income tax, with special reference to the 1984 amendment.

HISTORICAL BACKGROUND

When, in 1941, income tax was first introduced into Israel (at that time Palestine, under the British Mandate) neither residency nor nationality had been adopted as basic principles for determining the territorial scope of income tax. Instead, the Income Tax Ordinance sought to impose the tax on "income accruing in, derived from, or received in Israel".

The reasons for preferring the principle of the "source" of income to that of the "personal status" of the taxpayer were stated in the Report of the "Interdepartmental Committee on Income Tax in the Colonies not Possessing Responsible Government".[2] The Model Appendix 1 of the Report is the one upon which the Income Tax Ordinance, 1941, was based. With regard to the "scope of income tax", the Report states:[3]

> After careful consideration we have come to the conclusion that the most appropriate scheme for the Colonies generally is one which imposes tax upon income which either has its origin in the Colony, or, while having its origin outside the Colony, is received in the Colony. The adoption of this straight-forward rule does not result in anything more than the taxation of income that comes within the Colonial jurisdiction; moreover, it not only avoids the various difficulties inherent in an Income Tax code under which the amount to be charged depends in part upon whether the person is resident or non-resident, but also reduces the problems arising out of double taxation of income to comparatively small dimensions.
>
> Admittedly, there are attractions in seeking to impose the tax on the incomes of residents in the Colony wheresoever arising, and whether remitted to the Colony or not, and we are aware that tax has been so imposed in more than one instance. We feel, however, that the complications and difficulties which necessarily accompany this method of taxation are so great that, in the special circumstances of a comparatively small community, it is in the best interests of a Colony to limit the scope of the Income Tax charge to income which arises in the Colony or is brought into the Colony.

The basic provision which was introduced in 1941 (now s. 2 of the Income Tax Ordinance) has never been expressly replaced by the principle of residency or nationality. The phrase "income accruing in, derived from, or received in Israel", has been interpreted by the Courts of Law as meaning that a taxpayer will be liable to tax if he has income from a "source" which is situated in Israel, or if he "receives" in Israel income from a "source" wherever situated (i.e. even outside Israel).[4] *In principle*, the taxpayer's nationality or residence has remained irrelevant.

THE DEVELOPMENT OF THE "SOURCE" PRINCIPLE

The principle of "source" has been considerably modified, by limiting the tax liability of non-residents on the one hand, and by extending the tax liability of Israeli residents (or, in certain cases, Israeli nationals) on the other hand.

As noted, the "source" principle has basically remained unchanged, but in effect it has been substantially eroded. The modification of the principle has been carried out by two methods.

One method has been to introduce provisions, under which, in certain cases, income, though having its origin outside Israel (and presumably also not remitted to Israel), and hence non-taxable, shall nevertheless be deemed to be income accrued in or derived from Israel. Some of those provisions have been introduced

1. Income Tax Ordinance (Amendment No. 59) Law, 5744-1984, *Sefer Ha-Chukkim* No. 1107 of 23 February 1984, p. 56. See also Income Tax Rules (Deduction of Certain Expenses) (Amendment No. 2), 5744-1984, *Kovetz Ha-Takanot*, No. 4690, of 21 August 1984, p. 2378.
2. Cmd 1788.
3. Ibid, p. 5.
4. The interpretation of the courts has caused some controversy because the word "source" does not appear in the wording of s. 2.

to fill a gap and assume the nature of anti-avoidance legislation. In some of the "deeming" provisions the test of "residency", or "nationality" has been expressly mentioned.

RESIDENCY USED AS A BASIS FOR IMPOSING CAPITAL GAINS TAX

An example of using the "residency" criterion in the Income Tax Ordinance is s. 90, relating to capital gains tax. The Income Tax Ordinance, which was modelled on the British tax system, originally did not tax capital gains, but only income of a "revenue" nature. Capital gains tax was first introduced by the Israeli Parliament (Knesset) in 1952. (In 1962 capital gains tax was introduced in the U.K.) The capital gains tax was very limited in scope in 1952. Gradually it has been extended. In that new legislation the Israeli Legislature adopted the "residence" test, or the place where the asset sold is situated.

S. 89(b) provides that capital gain shall be deemed to have been accrued or derived from Israel, whether the sale was executed in Israel or outside Israel in any one of the two following cases:

(1) the seller is an Israeli resident;
(2) the seller is a non-resident, but the asset is situated in Israel, or the asset is situated outside Israel, but the asset sold constituted a right in respect of an asset situated in Israel, directly or indirectly (e.g. shares in a holding company which owns an asset in Israel).

It may be of interest to note that estate duty, which was introduced into Israel in 1949, was also levied according to the principle of the deceased's residency as well as the principle of the location of the property. Where the deceased was an Israeli resident his estate, for estate duty purposes, included all his property wherever situated. Where the deceased was a foreign resident, the tax was levied on his property situated in Israel.[5] When the *Likud* party came to power in Israel, it moved the Knesset (the Israeli Parliament) to abolish estate duty. In 1981 the Estate Duty Law, 5709-1949, was abolished and since then there has been no estate duty in Israel.[6]

DEFINITION OF A RESIDENT AND A NON-RESIDENT

When applied to an individual, a resident has been defined as an individual who resides in Israel except for such temporary absences as may seem reasonable to the Assessing Officer and not inconsistent with the claim of such individual to be resident in Israel.

When applied to a body of persons a resident is defined as follows:

> (1) A body of persons registered in Israel, having its main activity in Israel; provided that, if it is registered as a foreign company, it shall be regarded as an Israeli resident only if it so requested. Once so requested, it would not be able to change its mind before three years have elapsed, unless granted permission by the Minister of Finance.
> (2) A body of persons with control and management of the business exercised in Israel.
> (A free translation from the Hebrew text).

An individual or a body of persons not included in the definition of an Israeli resident are regarded as "foreign residents" (or "non-residents"). It follows that the two definitions are mutually exclusive.

The tests of "control" and "management" for defining a company's (and other bodies of persons) residency are accumulative and not alternative. The Treasury would have preferred the tests to be *alternative*, but apparently did not succeed in amending the definition in this respect. It may be of interest to note that, in a more recent definition of a resident company (and other bodies of persons), for the purpose of a law imposing a tax on property, which was enacted as a provisional measure in 1985, those two tests have been used as alternatives. The definition in that law includes, inter alia, a body of persons "the control *or* management of whose business is exercised in the region (meaning the occupied territories) by an individual who is an Israeli resident, whether directly or indirectly".

Non-residents have been granted various exemptions and reliefs. For example: s. 10 of the Income Tax Ordinance provides that

> tax shall not be payable in respect of any income arising outside Israel and received therein by any person who is in Israel for some temporary purpose and not with the intent to establish his residence therein and who has not actually resided in Israel at one or more times for a period equal in whole to six months in a tax year.

Another example is s. 14A of the Ordinance, which provides that a company, the control and management of whose business are exercised abroad, which received in Israel income accrued or derived abroad, may apply to the Minister of Finance for a relief and the Minister is empowered to reduce its rate of tax to a maximum of 15%. In special cases the Minister is empowered to exempt the company from tax entirely.

Israel is also a party to numerous tax treaties for the avoidance of double taxation.[7]

COUNTERACTING TAX AVOIDANCE BY USING THE OCCUPIED TERRITORIES AS A TAX HAVEN

Another example of using the personal attachment to the state (rather than the "source" principle) is s. 3A of the Income Tax Ordinance. S. 3A was added in

5. For more details see A. Lapidoth, "Territorial Limits of Fiscal Authorities on Succession and Wealth Taxes", Israeli report to the 22nd Congress of I.F.A., Studies on International Fiscal Law, vol LIII, part II, p. 207.
6. Estate Duty (Abolishment) Law, 5741-1981, *Sefer Ha-Chukkim* No. 1015 of 3 April 1981, p. 160, s. I.
7. For an example of exempting a British company from Israeli tax because of the tax treaty with the United Kingdom see C.A. 196/65, 19 *Piskei Din* (Part 3), p. 349.

order to counteract tax avoidance schemes which used the occupied territories as a tax haven. It lays down, inter alia, that the income of an Israeli national accruing in, derived from or received in the occupied territories shall be deemed to have been accrued in, derived from or received in Israel.

"Israeli national" is defined as in the Nationality Law, 5712-1952 or it is a company resident in Israel.

On 11 July 1984 the Land Appreciation Tax Law was amended with a view to applying the provisions of the Law to transactions in land in the occupied territories carried out by Israelis. An Israeli national who sells or purchases real property situated in the occupied territories shall be deemed to sell or purchase real property situated in Israel.[8] The term Israeli national, in this context, has been defined as: (1) a person who is registered, or must be registered, in the Israeli population registry; and (2) body of persons resident in Israel. The terms "body of persons" and "resident" have been given the same definition as in the Income Tax Ordinance.

THE "SHALL BE DEEMED TO" PROVISIONS OF SS. 4 AND 5 OF THE INCOME TAX ORDINANCE

The erosion of the concept of "source" began a few years after the introduction of income tax in 1941.

The first case (now stipulated by s. 4 of the Income Tax Ordinance) was introduced in 1945. If a product is exported out of Israel the full profits arising from the sale of the product shall be deemed to have been accrued or derived in Israel, regardless of the place where the contract was made. The purpose of s. 4 was apparently to fill a gap used for a scheme of avoidance, under which the Israeli exporter will receive a small profit while the main profit arising from the export will be artificially received by a foreign agent. Specific legislation to counteract tax avoidance through transfer pricing manipulation is common also in tax systems of other countries.[9]

The main "shall be deemed to" cases have been laid down in s. 5 of the Income Tax Ordinance. S. 5 lays down four cases, in which income shall be deemed to have been derived from Israel, without prejudice to any law regarding the territorial scope of tax. S. 5(1) deals with business income (including income from profession or vocation): ss. 5(2) and 5(3) deal with employment income and s. 5(4) deals with interest, rental and royalties.

The 1984 amendment concerned s. 5(1). Hence, it may be more convenient to deal with the other paragraphs of s. 5 first.

Ss. 5(2) and (3) deal with employment income. Under s. 5(2) employment income of either an Israeli resident or a non-resident shall be deemed to have been derived from Israel (and hence taxable) if the work was carried out in Israel. There is only one proviso, i.e. the provision will not apply where the said work was done by a non-resident, whose employer is also a non-resident, provided that the non-resident employee stayed in Israel, during one tax year, not more than 90 days (not necessarily consecutively) and the income did not exceed a certain amount. On 23 July 1986 a Bill amending the Income Tax Ordinance (Amendment No. 69) Law, 5746-1986, was published (in *Hatzaot Chok* No. 1791, of 23 July 1986, p. 258). The Bill includes a proposal to replace the present outdated amount of IL 50,000 by NS 5,000 (about US$ 3,333). It is also proposed linking the amount to the cost of living index.

The requirement that the employer also should be a non-resident, in order that the non-resident employee may benefit from the exemption, was added by Income Tax Ordinance (Amendment No. 21) Law, 5735-1975.[10]

S. 5(3) deals with an Israeli resident employee working abroad for an Israeli resident employer. During the first 4 years after leaving Israel the Israeli resident will be liable to pay tax in Israel and his "employment income" shall be deemed to be derived from Israel. Where the employer is the State of Israel (or other "public body" specified in the provision) there is no four-year limit. The Minister of Finance has been empowered to determine what is a "public body" for the purposes of s. 5(3).

Presumably after 4 years the link of the Israeli-resident employee with his home country is weakened, a presumption which is not valid where his employer is the State of Israel or other "public body".

The "deeming" provision of s. 5(3) may cause double taxation because the Israeli resident working abroad will most probably have to pay tax in the country where he carries out his work. Since Israel does not have tax treaties with *all* countries, such Israeli resident will be entitled to a unilateral tax relief.

S. 5(4) deals with payments of interest (including linkage differentials), rentals and royalties, made by the State or an Israeli resident. Such payments shall be deemed to have been derived from Israel and hence charged to tax by the recipient, even though the "source" of the payments may not be in Israel, and the recipient did not "receive" them in Israel. For example, a non-resident supplier who gives credit to his Israeli customer will have to pay tax (deducted at source) upon the payment of interest.

There are certain exceptions to the rule. Also, the Minister of Finance is empowered to grant a special exemption in respect of payments made for chartering aircraft or ships for international transport as well as interest paid on loans for purchasing such aircraft or ships.

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8. S. 16A, added by Appreciation Tax (Amendment No. 15) Law, 5744-1984, *Sefer Ha-Chukkim* No. 1121 of 11 July 1984, p. 179.
9. See, for example, David R. Davies, *Principles of International Double Taxation Relief*, London, Sweet and Maxwell, 1985, p. 11, § 1.14.
10. *Sefer Ha-Chukkim*, No. 756 of 31 January 1975, p. 42.

S. 5(1) OF THE INCOME TAX ORDINANCE

S. 5(1) was first enacted in 1946. Under the original wording it stated that "the whole of the income derived by any person in respect of gains or profits from any trade or business shall be deemed to be derived from Israel if the control and management of such trade or business is exercised in Israel".

It may be of interest to note that, until 1978, the only definition of "resident company" (including other "bodies of persons") was a company, "the control and management of whose business is exercised in Israel".

The accumulated effect of both s. 5(1) and the definition of "resident company" was that, as far as a company is concerned, the charge to tax on business income was in effect determined in accordance with residency. However, in 1978 the definition of resident company was extended to cover a company registered in Israel and having its main activity in Israel.[11]

The curious result is that the question whether a company will be taxed in Israel because of its Israeli residency will depend upon the criterion used for determining its residency. If it is regarded as a resident because the management and control of its business are exercised in Israel then its income will be deemed to have been derived from Israel and hence taxable. If, on the other hand, it has been classified as resident because it is registered in Israel and has its main activity in Israel, being a resident by itself will not render the company liable to Israeli tax. Its liability will be determined by the basic principle of "source", subject to any specific tax reliefs.

There is scarcely any reported case where the Israeli courts of law were faced with the problem of defining residence of a company for income tax purposes. In a fairly recent case the Court had to decide whether a company acting outside Israel was resident in Israel. The company was registered in Israel, but there was ample evidence that its main activity, as well as the management of its business, were outside Israel. Hence, it was decided that the company was not an Israeli resident.[12]

It is probable that the courts would follow the British case law on the interpretation of the phrase "control and management" of the company's business for determining the company's residence.[13] However, there is a growing tendency in Israeli courts of law to seek guidance in American decisions. An interesting illustration is the decision of the Supreme Court in C.A. 389/82,[14] which involved the question what was the residency of a German company for the purposes of the Israeli Value Added Tax Law, 1975. Although the definition of residency for VAT purposes is different from the definition of resident company for income tax law, it may be of interest to note that the Court declined to apply, to the VAT case before it, the test of company residence for income tax purposes, as laid down in British case law. The Court found support for its decision in American Law, which was brought by the Court for the sake of comparison.

A recent amendment of the VAT Law has replaced the definition of "residency", for VAT purposes, by a definition similar to the one used for income tax purposes. See Value Added Tax (Amendment No.6) Law, 5746-1986, passed by the Knesset on 5 August 1986 (not yet published).

As far as income tax is concerned, on 23 July 1986 a blue print was published, including the Bill amending the Income Tax Ordinance (Amendment No. 69) Law, 5746-1986 (*Hatzaot Chok* No. 1791 of 23 July 1986, p. 258). The Bill proposes to amend the definition of "residency" of a company (and other "bodies of persons") by empowering the Minister of Finance to specify the circumstances which will imply the existence of "management and control", thus helping the Revenue to establish the place of the company.

THE 1984 AMENDMENT

S. 5(1) of the Income Tax Ordinance was further extended in 1984. The amendment, which came into effect as of 1 July 1984, is popularly known as the "professors' amendment". This is because it has removed the opportunities which the academic staff had to escape Israeli tax when, while on their sabbaticals, they were employed by foreign universities abroad and the salary received by them was spent abroad. They therefore claimed that the income was neither "received in Israel" nor was it "accrued in or derived from Israel". The Treasury denied that the amendment was aimed at taxing the professors' remuneration during their sabbaticals. The purpose of the amendment, the Treasury claimed, was conceptual.

In any case, the effect of the amendment has been to further erode the "source" method.

The drafting technique used for extending the "deeming" clause in s. 5(1) was the introduction of an extensive definition for the term "vocation". Until the 1984 amendment "vocation" was defined only as "profession and any other vocation which is not business". Now it also includes the following:

(a) "vocation" – whether the income derived from the vocation is charged to tax under s. 2(1) or s. 2(2);
(b) vocation engaged by any person abroad shall not be regarded as different from the vocation engaged by him in Israel only because in Israel the income from the same vocation was charged under s. 2(1) whereas abroad it was charged under s. 2(2) or vice versa;
(c) a person engaged abroad in the same vocation that he performed in Israel shall be regarded as ordinarily performing the same vocation in Israel as long as he is an Israeli resident".

To paraphrase the new definition one has to begin at the end. An Israeli resident will be liable to pay tax in Israel on income which he derives from a profession or vocation carried out by him abroad (including

11. Income Tax Ordinance (Amendment No. 32) Law, 5738-1978, *Sefer Ha-Chukkim* No. 910 of 22 August 1978, p. 216. For the full definition of a company resident see supra.
12. Criminal Appeal 123/83 *Collection of Civil Decisions*, Vol. 12, p. 291.
13. For a summary of the British law on residence of companies see David R. Davies, ibid, p. 16, § 2.03.
14. *Piskei Din*, Vol. 37 (Part I), p. 572.

employment income) if the profession or vocation are the same as the one performed by him in Israel. A vocation will not cease to be regarded as the same only because the taxpayer was self-employed in Israel (had income charged under s. 2(1)), whereas abroad he was an employee (had income charged under s. 2(2), or vice versa.

The meaning of s. 5(1)(c) is not clear, and may give rise to various problems of interpretation. For example: does it merely lay down an irrebuttable presumption that as long as a resident of Israel performs abroad the same vocation that he performs in Israel he is regarded as "ordinarily performing that vocation in Israel", and hence he comes within the ambit of s. 5(1)? Or, does it perhaps say that s. 5(1), as far as vocation is concerned, applies only to Israeli residents as long as they are residents, excluding non-residents?

It is not altogether clear how, if at all, the 1984 amendment will affect the tax liability of a non-resident. The answers to those questions may be linked to another problem which may arise, i.e. whether the new test, introduced by the 1984 amendment, is exclusive. That is, does the new test exclude the tests which have been used for determining the scope of tax under the "source" method? S. 5 opens with the phrase "without prejudice to any provision of the law regarding the scope of tax". It therefore seems to follow that the new tests laid down in s. 5 are *in addition* to the old tests. However, a similar question arose in C.A. 289/68[15] and the Supreme Court was apparently of a different opinion.

The issue in that case was, what is the correct interpretation of s. 5(2) of the Income Tax Ordinance as introduced in 1965? S. 5(2) looks to the situs of the work to determine whether employment income is charged Israeli income tax. Furthermore, s. 5(2) exempts from tax, since 1975, a non-resident employee employed by a non-resident employer), who stays in Israel less than 90 days in a given tax year, his income not exceeding a certain amount. The taxpayer in C.A. 289/68, an Israeli company named "Giora Godik International Productions (1965) Ltd.", employed 5 non-resident experts for less than 90 days in a tax year and paid each of them less than the maximum salary exemption from tax under s. 5(2). The Treasury argued that the company had to deduct tax at source since the employment income was not exempted from tax. The Treasury's argument was that the liability to tax of the employment income was not based on s. 5(2), but on the tests used for the "source" method which is the basis of the scope of tax under s. 3, i.e. income "accrued in, derived from, or received in Israel". Those tests, as applied to employment income, were not the place where the work is performed, but rather the place of the contract or the place of the payment. Therefore, the Treasury argued, there was no need to invoke s. 5(2), and consequently the taxpayer could not benefit from the exemption granted under s. 5(2). According to that argument, which, it is submitted, is well grounded on the literal interpretation of s. 5(2), the "deeming provisions" were not intended to derogate from the general principle of source. If and when s. 5(2) applied, the taxpayer was entitled to the exemption. The Court, however, did not accept the interpretation suggested by the Treasury.

It appears that the Supreme Court was ready to accept that those tests, which had been laid down by the British Courts of law, should be followed *before* 1965. The question, however, remained whether the tests should continue to be applied *after* the enactment of s. 5(2) in 1965. The Court decided that the new test, the place where the work is performed, which has been laid down in s. 5(2), is an *exclusive* test. Although s. 5 opens with the phrase "without prejudice to any provisions of the law regarding the scope of tax", it is clear that as far as employment income is concerned, the legislature intended to replace the British tests by the new test. The old tests should not be used after 1965.[16]

It is not clear whether the same attitude would be adapted towards the interpretation of s. 4(1)(C) which was introduced in 1984.

SUMMARY AND CONCLUSION

The "source" method for determining the liability to tax in the Israeli tax system was not adopted inadvertently. It was preferred to the taxpayer's personal attachment to the State, after careful consideration, because it was thought to be more suitable to the conditions of Israel's economy in 1941 (Palestine, under the British Mandate). Those conditions have changed considerably and it is most doubtful whether the "source" method is still suitable.

The need to modify the "source" method has not escaped the Legislature. For the last 40 years the law has been increasingly amended, mostly by introducing "deeming" provisions, with a view to modifying the "source" doctrine. Many amendments have in effect sought to impose the tax on the basis of the taxpayer's personal attachment to the State, mainly resorting to the test of "residency". The tendency culminated in the 1984 amendment, which extended the tax liability of an Israeli resident on professional income abroad.

One can understand the reluctance of the Legislature, especially in the tax area, to depart from a well established basic concept and expressly replace it by an entirely different concept. The reluctance is greatly due to the fear that the draftsman might not foresee all the possible consequences of the change and fail to guard against unexpected loopholes. In the present case, however, the Legislature appears to have been overcautious. The numerous "deeming" provisions have resulted in a cumbersome set of rules which make it hard to determine the state of the law.

It is time to reassess the concept of "source" with a view to replacing it by "residency". The law in this tax area should be made simpler and clearer, and also brought more in line with the 1977 "model convention" for the avoidance of double taxation recommended by the OECD.

15. C.A. 289/68, 23 *Piskei Din* (Part I), p. 36.
16. See also C.A. 36/69, 23 *Piskei Din* (Part II), p. 295.

U.S.A.:

The New California Unitary Tax Law

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On 5 September 1986, Governor Deukmejian signed Senate Bill (S.B.) 85, which provides corporations doing business in California an election to file a combined unitary tax return excluding most foreign corporations. As a result of last minute scrambling seeking a political compromise, many of the details in the bill did not receive careful legislative scrutiny. This article outlines the principal provisions of the bill and describes some of the problem areas.

1. WATER'S-EDGE ELECTION

Under existing law, a corporation doing business in California is required to file a combined unitary tax return including both foreign and domestic corporations in the pool of income subject to apportionment if the corporation doing business in California is considered to be engaged in a single economic enterprise with the other corporations. Under the new law, a qualified taxpayer may elect to determine its income in California pursuant to a "water's-edge" election that excludes most foreign corporations from the unitary group. A qualified taxpayer is defined as a bank or corporation that consents to the taking of depositions of key domestic corporate officials regarding intercompany pricing and that agrees that dividends will be treated as business income when paid (a) by a more than 50% owned subsidiary in the same general line of business, or (b) from any corporation that is either a significant source of supply or customer. "Significant" is defined as 15% or more of input or output.

The election is made by contract with the Franchise Tax Board in the original return for a year and requires the consent of every affiliated bank or corporation subject to tax. The contract will be for a 10-year period, and will automatically be renewed annually unless notice of non-renewal is given. The election may be changed during the running 10-year period only with the permission of the Board, which is empowered to impose conditions to its approval, including the reporting of income in the year in which the election is changed.

A. Election fee

The water's-edge election requires the annual payment of an election fee, which in effect is in the nature of an additional tax. The amount is equal to .03% (three basis points) of the sum of the taxpayer's California property and payroll in the income year ending during calendar year 1986, plus sales in the current income year. Intangibles are not included in the property factor, but income from intangibles is included in the sales factor. The election fee may be reduced, but not below .01% (one basis point) of *current* property, payroll, and sales by reducing the tax base by new California investment and new California payroll expense accumulated after 1 January 1988. Since the minimum fee is based on current property and payroll, it is possible that the .01% minimum fee could exceed the .03% base fee. The fee will not be imposed for an income year in which the taxpayer has losses both in a domestic and in a worldwide combination.

Unlike the California Uniform Division of Income for Tax Purposes Act, the bill does not provide for modification of the apportionment formula provisions used to calculate the election fee to provide a reasonable measure of property, payroll or sales when distortions arise. Thus, for example, agencies of foreign banks that engage in large dollar volume, low spread purchases and sales of overnight funds from other banks, where the normal spread may range from 6 to 12 basis points, will find that the election fee will range from 25% to 50% of gross profit. Either the law will have to be modified, placing the Franchise Tax Board consent to accounting for these revenues on a more realistic basis (such as by only reporting the spread as income), or these activities moved to another state, for the election fee will exceed net income from such activities.

B. Corporations included in the water's-edge group

Corporations in the water's-edge group include banks and corporations eligible to file a federal consolidated return (which includes both domestic corporations and certain Canadian and Mexican corporations), domestic international sales corporations (DISCs), foreign sales corporations (FSCs), foreign and domestic corporations with more than 20% of their property, payroll, and sales in the United States, U.S. corporations having more than 80% of their business outside the U.S. (so-called 80-20 corporations, but the Board is directed to study and report prior to 1 March 1987 the equity of this treatment), export trade corporations, and "deemed subsidiaries" of foreign banks and corporations having a U.S. branch, but having less than 20% of their property, payroll, and sales in the U.S. (the income of the "deemed subsidiary" being equal to income reported for federal income tax purposes). Also included are controlled foreign corporations to the extent of the ratio of Subpart F income to earnings and profits.

The corporations listed above will be included in a water's-edge group only if they would be included in a combined unitary tax return under existing law. The intent of the law is not to change the rules for determining whether a corporation is engaged in a unitary business with the other entities in the water's-edge group. If an affiliated group is engaged in two or more unitary businesses all affiliated taxpayers must still consent to the water's-edge election.

C. Corporations excluded from the water's-edge group

Foreign corporations, other than those includible above, are excluded from the water's-edge group. U.S. possession corporations are also excluded.

D. Deemed subsidiary

Many questions arise in determining the separate income of a deemed subsidiary of a foreign corporation. To the extent that federal law differs from state law and an election is available under federal law, will taxpayers be able to make an election different from that used for federal purposes? It appears that deemed subsidiaries will be entitled to a net operating loss deduction not available to regular corporations: will carryovers from prior years be allowed? Where federal law differs from state law, as for example in computing bad debt and depreciation deductions, how are opening balances determined? A water's-edge election might be made, not to avoid worldwide combination, but to qualify for a net operating loss deduction.

E. Validity of election fee

Litigation is pending over the constitutionality of combining foreign parents with U.S. subsidiaries for taxable years prior to the effective date of S.B. 85. If the courts ultimately hold that California may not include foreign parents (and foreign subsidiaries of foreign parents) in a unitary tax return, it seems likely that the election fee imposed to avoid worldwide combination will also be invalid.

2. PARTIAL EXCLUSION OF FOREIGN-SOURCE DIVIDENDS

Domestic corporations had complained that earlier versions of water's-edge bills in the California legislature favored foreign-based multinationals, because exclusion from a unitary return of foreign subsidiaries of domestic corporations would cause dividends from the foreign subsidiaries to be subject to tax, while dividends paid by U.S. subsidiaries to foreign parents may not be taxed by the country in which the foreign parent was located. S.B. 85 provides a partial exemption from taxation of foreign-source dividends.

An extremely complex mechanism seeks to provide for a basic deduction of 75% of dividends from foreign corporations more than 50% owned. In an effort to encourage job development in California, to the extent that the percentage of foreign payroll to total payroll increases from the base period 1984-1986, the percentage of excluded foreign dividends will decrease, while the percentage of excluded foreign dividends will increase where the foreign payroll percentage decreases.

A. Interest offset

Under existing law, the "interest offset" provision of Revenue and Taxation Code (R&T) §24344 would operate to disallow as a business deduction interest expense incurred in an amount equal to dividend income not subject to apportionment. S.B. 85 amends R&T §24344 to provide that there will be no interest offset attributable to dividends deductible under new R&T §24411. However, the conference committee added a new subsection (c) to R&T §24344 that states "interest expense incurred for purposes of foreign investments may be offset against dividends deductible under Section 24411". It is not clear whether this new subsection (c) applies only to new borrowings after the effective date of the bill, and whether a direct tracing of borrowing to foreign investment is required to invoke the interest offset.

B. Other problems

1. Section 24425 of the California Revenue and Taxation Code disallows expenses incurred to earn non-taxable income. This section has been applied to disallow interest and other expenses where non-taxable dividend income is received. *Great Western Financial*

Corp. v. Franchise Tax Board, 4 C3d 1 (1971). S.B. 85 is silent on the effect of new §24411 on §24425. It might be presumed that R&T §24425 would not apply; otherwise, the amendment to R&T §24344 would be hollow. The issue requires clarification.

2. The deduction is available only to dividends paid by more than 50% owned subsidiaries. It is possible to have unitary dividend income from foreign subsidiaries less than 50% owned and thus not eligible for unitary combination. No policy reason is readily apparent why unitary dividend income from less than 50% owned subsidiaries not combined should be fully included in apportionable income, while unitary dividend income from more than 50% owned subsidiaries not combined should be subject to a 75% deduction.

3. The adjustment scheme involving foreign payroll will produce inequities with the passage of time. For example, a corporation with no foreign payroll in 1984-1986 will never qualify for any foreign dividend deduction.

4. S.B. 85 does not contain any transition rules with respect to accumulated earnings and profits of foreign subsidiaries derived in years where a worldwide unitary tax return was filed. If the Board follows a last in, first out method of determining the earnings and profits out of which dividends are paid (as it dit when R&T §25106 was added to the Code fully exempting dividends from a combined subsidiary), dividends which may be paid tax-free before 1988 may be partially or fully taxable when paid after 1987.

3. OTHER PROVISIONS

S.B. 85 provides for the filing with the Franchise Tax Board of a domestic disclosure spreadsheet comparable to the one proposed in S.1974 in the United States Senate. Other provisions prescribe penalties for noncompliance with information reporting requirements.

In an effort to reduce the expected tax loss from adoption of a domestic water's-edge election, S.B. 85 makes changes to substantive tax law that will produce replacement revenue, dealing with accrual of vacation pay, installment reporting of income, and computation of bad debts under the reserve method by corporations other than financial institutions.

4. PLANNING

a. Should a corporation make a water's-edge election? Since the election can cost a very substantial fee, an election may convert full exempt foreign-source dividends to partially or fully taxable dividends, and since the election can be revoked at best only nine years in the future, a corporation must be fully confident in its ability to predict changes in its operations and in the worldwide economy over the next decade before making an election.

The bill does not address the question whether a corporation can re-elect to file on a water's-edge basis subsequent to termination of an election. If a re-election would be allowed, a corporation should terminate the election at the end of the first year.

Election by foreign-based taxpayers may be indicated where substantial new investment in California expected to produce start-up losses for a period of years will be incurred, where the expense of complying with worldwide combination is excessive, or where distortions in computation of worldwide income as a result of such factors as changes in the exchange rate exist. Foreign-based taxpayers with less than 20% of their business in the United States may want to consider the availability of the net operating loss deduction and other consequences of substitution of substantive federal tax law for existing California tax law.

Both foreign and domestic taxpayers should consider requesting a private ruling from the Franchise Tax Board if uncertainty continues to exist on an issue that might influence the decision whether to elect.

Domestic corporations must, in particular, do some soul searching before making the water's-edge election. Clarification of the uncertainties involving §24344 and §24425 should be obtained before an election is made.

b. Should dividends be paid in 1986, as dividends in a base period affect calculation of the §24411 deduction? In general, a larger base period dividend reduces the potential disallowance resulting from an increased foreign payroll factor, while reducing the amount of foreign dividends eligible for 100% deduction. Each corporation must evaluate their own particular experience and prospects. Federal income tax consequences may well dominate.

Pending clarification of the accounting rules of payment of dividends out of income earned in a worldwide combination year, it may be advisable to pay dividends from such income prior to 1988.

c. Should foreign payroll be increased in 1986? In general, the greater the foreign payroll in 1986, the greater the amount of foreign-source dividends deductible in subsequent years.

BOTSWANA:

Why Rate Reductions are not a Substitute for Inflation Adjustment of the Personal Income Tax Base

By Parthasarathi Shome and Alfred H. Dalton*

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1. INTRODUCTION

Quite a few countries have recently reduced the top marginal tax rates of personal income, sometimes known as "supply-side" tax reform. These changes have been made primarily on efficiency grounds; reducing the complexity in the tax structure which arises from a proliferation of marginal rates would, in turn, improve administration, reduce evasion, possibly not affect revenue adversely, and might even allow an across-the-board scaling down of marginal rates in the medium term.

In 1983-84, Botswana reduced its top marginal rate from 65% to 60% and modified some of the other marginal rates as well (Appendix I).[1] It was found during a recent International Monetary Fund (IMF) tax mission to that country that this reduction, coupled with the effects of "fiscal drag",[2] while having been introduced on efficiency grounds, have had an anomalous distributional impact in favor of the top income groups. In what follows, an analysis of this finding is presented.

2. COMBINED EFFECT OF "FISCAL DRAG" AND REDUCTION IN MARGINAL TAX RATES

In Botswana, because household exemptions from the personal income tax have not been increased in line with inflation, the proportion liable to tax has been increasing steadily in recent years. The exemptions were unchanged for the period July 1980 to July 1984, and the rates of tax and rate bands also were stationary until the rate schedule was eased in 1983-84 and again in 1984-85, in which year exemptions were also increased by some 11%. Table 1 sets out these changes

Table 1

Botswana: Percentage rates of tax applicable to personal incomes, 1980-81 to 1984-85

Taxable income[1] in pula	*1980-83*	*1983-84*	*1984-85 et seq.*
First 1,000	10	5	5
Next 2,000	10	10	10
Next 4,000	20	17.5	15
Next 4,000	30	27.5	25
Next 6,000	40	37.5	35
Next 6,000	50	37.5	35
Next 2,000	50	50	45
Next 18,000	60	50	45
Next 2,000	60	60	55
Next 18,000	65	60	55
Remainder	65	60	60

Sources: Appendix I, and Income Tax (Amendment) Act, 1984.

1. Taxable income is total income, less the appropriate "household allowance" and any other deductions due (insurance, interest, education, and medical allowances).

in the rate schedules, but it is to be noted that apart from the reduction in the maximum rate from 65% to 60%, the changes hardly reflect inflation over the period. To take just one example, if the bands for the first 7,000 P of taxable income in 1980-81 – up to which the tax rate did not exceed 20% – were fully indexed, a taxable income of nearly 11,000 P would have to be reached in 1984-85 before a marginal tax rate of 20% would apply.[3] But, in fact, a rate of 25% applies in the latter year within the taxable income band of 7,000 P to 11,000 P.

* Views expressed represent the opinions of the authors and, unless otherwise indicated, should not be interpreted as official Fund views.

1. A further change in the rate schedules was introduced in 1984-85, mainly decreasing the marginal rates while maintaining the top rate of 60%, however, for a higher income band (Table 1).

2. "Fiscal drag" or "bracket creep" can be defined as the problem of individuals finding themselves in higher income tax brackets as a result of inflation even when their real incomes might have remained the same or even declined.

3. The figure of 11,000 P is derived by applying a multiple of 1.56 to 7,000 P corresponding to the increase in the CPI from August 1980 (= 100) to August 1984 (= 155.6).

Since household exemptions have not increased and taxable income bands not revised in line with inflation, the effective rates of tax on personal incomes increased sharply over recent years, except for very large incomes which benefited from the reduction in the maximum rate from 65% to 60%. The scale of this "fiscal drag" can be seen from Table 2 which compares the average rate of tax on specimen incomes of a married taxpayer in 1980-81 with average rates on the same *real* incomes in 1983-84. Chart 1 demonstrates the incidence effect of the fiscal drag more clearly.

It can be seen that the incidence on the very top income brackets has been favorable while it has been adverse to the majority of taxpayers. The average tax rates for all taxable incomes up to 50,000 P increased while those of incomes of 60,000 P and above fell. Since the latter group contains only 40 taxpayers approximately,[4] it can be argued that a small upper income group gained, while the majority of the taxpayers were affected adversely. Thus, even though, from an efficiency point of view, bringing down the marginal tax rates has been considered important and such a change in the rate schedule has been enacted, the effect of the "fiscal drag" must have been to neutralize the effect for most taxpayers.

Table 2

Botswana: Changes in average tax rates between 1980-81 and 1983-84 on constant real incomes

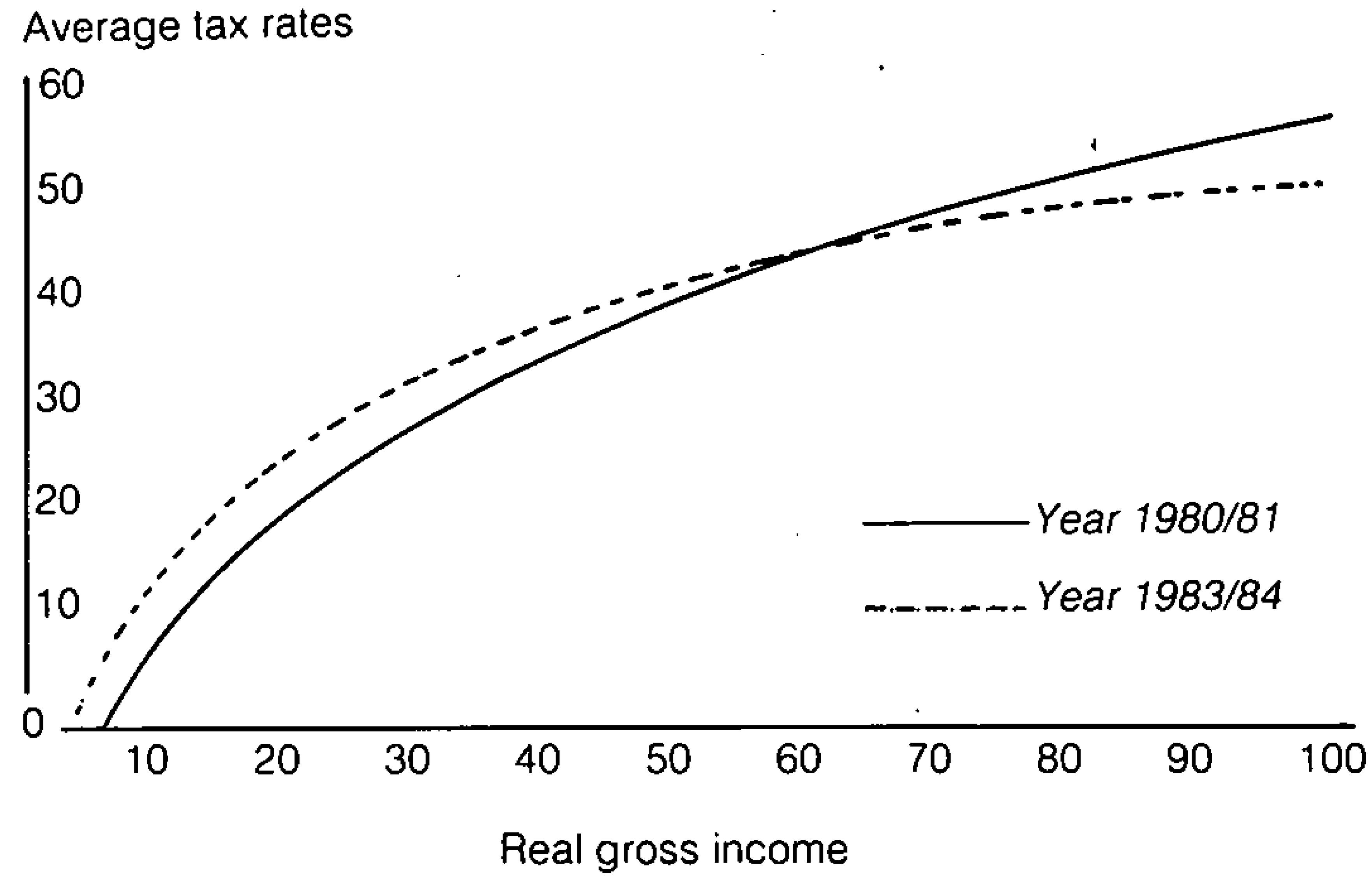
Gross income 1980-81 (in thousands of pula)	*Average tax rate 1980-81 (in %)*	*Equivalent income 1983-84 (in thousands of pula)*[1]	*Average tax rate 1983-84 (in %)*	*Approximate number of assessments in income band*[2]
4	1.0	5.7	2.8	5,000
6	4.0	8.6	6.9	2,800
8	7.2	11.4	10.8	2,700
10	9.8	14.3	13.7	2,000
12	12.7	17.2	17.5	900
14	15.1	20.0	20.4	800
16	17.9	22.9	22.5	600
20	22.3	28.6	26.4	550
30	31.8	42.9	34.2	600
40	38.9	57.2	40.1	210
50	43.2	71.4	44.1	70
60	46.9	85.7	46.7	35
70	49.2	100.0	48.6	20
80	51.4	114.3	50.0 }	
100	54.1	142.9	52.3 }	20
Over 100	—	Over 142.9	— }	

Sources: Appendix II, and staff estimates.

1. The 1980-81 money incomes were multiplied by 1.429, reflecting the rise in the CPI between August 1980 and August 1983.
2. These numbers of assessments in each income band are based on a distribution prepared by the Central Statistical Office (CSO) of the 16,700 assessments made in 1983-84. This distribution is not by gross income, but by taxable income (i.e. gross income, less the household deduction and any other deductions due). For the purpose of computing the numbers shown in this column, taxable incomes have been grossed up by the household allowance to convert them to a distribution of gross incomes.

Chart 1

Botswana: Effect of fiscal drag on average tax rates, 1980/81–1983/84



APPENDIX I

Table 3

Botswana: Changes in marginal rates of personal income[1]

Taxable income (in pula)		*Rate of tax (in %)*	*Tax within band (in pula)*	*Tax payable up to end of band (in pula)*
1980-81 and subsequent years				
First	3,000	10	300	
Next	4,000	20	800	1,100
Next	4,000	30	1,200	2,300
Next	6,000	40	2,400	4,700
Next	8,000	50	4,000	8,700
Next	20,000	60	12,000	20,700
Exceeding	45,000	65	—	—
1983-84 and subsequent years				
First	1,000	5	50	
Next	2,000	10	200	250
Next	4,000	17.5	700	950
Next	4,000	27.5	1,100	2,050
Next	12,000	37.5	4,500	6,550
Next	20,000	50	10,000	16,550
Exceeding	43,000	60	—	—

Source: Income Tax (Amendment) Act, 1980, 1983.

1. For the purpose of the exercise, only 1980-81 and 1983-84 schedules are presented here. It may be of interest to note that a further change in the rate schedules was introduced in 1984-85, mainly decreasing the marginal rates while maintaining the top rate of 60% for incomes of over 63,000 P (see Table 1).

4. As seen from the last column of Table 2.

3. CONCLUDING OBSERVATIONS

It is of some importance to note that even when marginal rates with respect to taxable income are reduced across-the-board as in Botswana (Table 1), adverse incidence effects might still result (Chart 1) in the absence of full indexation. Clearly, reduction of tax rates may be an inadequate compensation for "bracket creep". Depending upon the rates of tax rate reductions, there may be over-compensation, or under-compensation, reflecting the structure of the tax base. It would be only a coincidence if everybody was justly compensated. Only full indexation would achieve this goal.

It may be worthwhile mentioning that the above incidence exercise, the procedure for which is presented in Appendix II, could be performed for any reform package involving decreases in marginal tax rates before it is recommended, if equity is a stated objective. Further, from available figures or calculations regarding the number of taxpayers or assessments in each income band, it is also possible to obtain an idea about the numbers of individuals distributionally affected in either direction by such changes. In other words, the exercise could be used as a simple check to gauge the likely incidence of a supply-side oriented tax reform.

APPENDIX II

Table 4

Botswana: Average rates of personal income tax for a married taxpayer, 1980-81[1]

Gross income (in pula)	*Taxable income[2] (in pula)*	*Tax[3] (in pula)*	*Average tax rate (in %)*
4,000	400	40 = 40	1.0
6,000	2,400	240 = 240	4.0
8,000	4,400	300 + 280 = 580	7.2
10,000	6,400	300 + 680 = 980	9.8
12,000	8,400	1,100 + 420 = 1,520	12.7
14,000	10,400	1,100 + 1,020 = 2,120	15.1
16,000	12,400	2,300 + 560 = 2,860	17.9
18,000	14,400	2,300 + 1,360 = 3,660	20.3
20,000	16,400	2,300 + 2,160 = 4,460	22.3
25,000	21,400	4,700 + 2,200 = 6,900	27.6
30,000	26,400	8,700 + 840 = 9,540	31.8
35,000	31,400	8,700 + 3,840 = 12,540	35.7
40,000	36,400	8,700 + 6,840 = 15,540	38.9
45,000	41,400	8,700 + 9,840 = 18,540	41.2
50,000	46,400	20,700 + 910 = 21,610	43.2
60,000	56,400	20,700 + 7,410 = 28,110	46.9
70,000	66,400	20,700 + 13,910 = 34,610	49.2
80,000	76,400	20,700 + 20,410 = 41,110	51.4
90,000	86,400	20,700 + 26,910 = 47,610	52.9
100,000	96,400	20,700 + 33,410 = 54,110	54.1

Sources: Appendix I, and staff estimates.

1. All figures are rounded to the tens for calculations of both years.
2. Gross income minus 3,600 P, the latter being the married taxpayer's allowance in 1980-81.
3. The rate schedule presented in Appendix I is applied to taxable income.

Table 5

Botswana: Average rates of personal income tax for a married taxpayer, 1983-84

Gross income in 1980-81 terms (in pula)	*Equivalent income in 1983-84[1] (in pula)*	*Taxable income[2] (in pula)*	*Tax[3] (in pula)*	*Average tax rate (in %)*
4,000	5,720	2,120	50 + 110 = 160	2.8
6,000	8,570	4,970	250 + 345 = 595	6.9
8,000	11,430	7,830	950 + 228 = 1,178	10.3
10,000	14,290	10,690	950 + 1,015 = 1,965	13.7
12,000	17,150	13,550	2,050 + 956 = 3,006	17.5
14,000	20,000	16,410	2,050 + 2,029 = 4,079	20.4
16,000	22,860	19,260	2,050 + 3,098 = 5,148	22.5
18,000	25,720	22,120	2,050 + 4,170 = 6,220	24.2
20,000	28,580	24,980	6,550 + 990 = 7,540	26.4
25,000	35,730	32,130	6,550 + 4,565 = 11,115	31.1
30,000	42,870	39,270	6,550 + 8,135 = 14,685	34.2
35,000	50,020	46,420	16,550 + 2,052 = 18,602	37.2
40,000	57,160	53,560	16,550 + 6,336 = 22,886	40.1
45,000	64,310	60,710	16,550 + 10,626 = 27,176	42.3
50,000	71,450	67,850	16,550 + 14,910 = 31,460	44.1
60,000	85,740	82,140	16,550 + 23,484 = 40,034	46.7
70,000	100,030	96,430	16,550 + 32,052 = 48,602	48.6
80,000	114,320	110,720	16,550 + 40,632 = 57,182	50.0
90,000	128,610	125,010	16,550 + 49,206 = 65,756	51.4
100,000	142,900	139,300	16,550 + 57,780 = 74,330	52.3

Sources: Appendix I, and staff estimates.

1. The first column multiplied by 1.429, as obtained from the consumer price index.
2. The second column minus 3,600 P, the married taxpayer's allowance in 1983-84. In 1984-85, this allowance was increased to 4,000 P.
3. The rate schedule is applied from Appendix I.

INTERNATIONAL FISCAL ASSOCIATION NEWS

Resolutions XL IFA Congress, New York 1986

SUBJECT I
Transfer of Assets into and out of a Taxing Jurisdiction

Resolution (original version: French)

The XL Congress of IFA meeting in New York, as a result of its discussions, arrived at the

FOLLOWING FINDINGS:

1. The physical and non-physical transfer of assets, current or fixed, between tax jurisdictions, whether or not they are the result of a legal transfer of property, may give rise, sometimes even in a third country, to taxation in the absence of real profits. This is mainly the case where, as a result of the transfer, accrued appreciation is recognised although no realisation has occurred. Such taxation jeopardises tax neutrality, having an undesirable impact on business decisions, and hampers free physical and legal circulation of goods even among countries in the process of integration. The reason for this lies in the concern of the countries that taxable substance which they consider as attributable to them would be removed from their control and would ultimately escape taxation.

2. These problems are aggravated when the outgoing and incoming valuations, which are, respectively, the measure of the accrued appreciation for the departure country and which supply, for the country of entry, the basis for the ultimate taxation of capital gain and for amortization, are not the same. During the debates, it appeared that, whereas the departure country generally applies, for its valuation, the arm's length criterion, the country of entry uses other methods, such as historical cost reduced by amortization. This prevents an equitable sharing of taxable substance between the two countries and may lead to double taxation.

3. The examples which have been dealt with in the discussions have shown that these distortions may be particularly disturbing in the case of short-term establishments, such as construction plants and maritime oil rigs.

4. It appeared, first from the report, then in the discussions, that these problems are of little interest to those countries which, both in their internal law and in their treaties, apply worldwide taxation with a credit relief system ("credit countries"). For those countries, as a rule, there is taxation only when the transfer occurs between legal entities. Then these countries tax the entire capital gain, even that part of it which is attributable to the period during which the asset remained in the departure country, Thus, when the transfer occurs between two credit countries, the first one makes no claim to levy tax on the gain, whereas, if the transfer occurs from a country with a territorial or exemption system (exemption country) to a credit country, the available credit cannot always prevent the double taxation which may result from aggregating partial taxation in the departure country and total taxation in the country of entry. In this respect, it was also noted that, by virtue of the consistent application of their own tax rules throughout, the credit countries benefit from the tax sacrifice which may have been made by the departure country for the development of its economy, unless special rules provide otherwise.

5. The discussions highlighted the particular situation where the business of a permanent establishment of a foreign company is contributed in return for shares in a subsidiary in the country of the permanent establishment. Irrespective of whether the taxation method in either country is the credit or the exemption system, the taxation of the accrued appreciation should be deferred in such a way that the right to taxation is safeguarded, until the appreciation is effectively realised.

On the basis of these findings the XL Congress of IFA in the present stage of the study of these problems,

RECOMMENDS THAT:

I. To the extent that the right of the departure country to tax appreciation which has accrued under its jurisdiction is recognised:
   (a) taxation should be deferred until realisation; this can be achieved for example by providing for a reserve equal to the accrued appreciation, such reserve to be dissolved upon disposal of the goods, or, as to amortizable goods, as amortization progresses;
   (b) the outgoing and incoming valuations should, to the extent possible, be fixed by applying the same criterion, which should be the arm's length principle;

II. These objectives may sometimes be achieved internally, by administrative and judicial interpretation on the basis of general principles of tax law, and, internationally, by mutual agreement procedures. Time lags between taxation in the two countries may, as recalled by the resolutions of the 1981 XXXVth Congress in Berlin, require waiver of the statute of limitations. In cases that cannot be so ruled upon, legislation should be amended to satisfy the above objectives, either by harmonized unilateral measures, particularly among countries in the process of integration, by means of directives or model provisions, or by supplementing, preferably on the basis of additional provisions in the model conventions, the double taxation avoidance treaties.

III. In all these respects, it is desirable that this research subject be further pursued in future IFA works. Particularly mergers and other similar cross border reorganisations would be a worthwhile subject for IFA.

SUBJECT II
Currency Fluctuations and International Double Taxation

Resolution (original version)

TAKING NOTE of twenty-five National Reports and the General Report as published in Cahiers Volume LXXIb and

TAKING FURTHER NOTE of the discussions held during the Congress on 9 September 1986 in which it was generally accepted that

(a) there is a need for much greater certainty and consistency in the taxation of currency fluctuations
(b) all countries should work towards a uniform system for the taxation of currency gains and losses, thereby lessening the risk of double or otherwise excessive taxation
(c) there were great difficulties in finding solutions for the many problems identified in this area which were increasing with the wide variety of financial instruments now in use,

RECOGNIZING THAT

new legislative proposals such as those put forward in the U.S.A. and Australia, while useful in reducing the scope of the problem, do not provide a complete solution and include negative elements such as the characterization of currency gains and losses as deemed interest,

RECOMMENDS

1. The OECD and other international organisations should be encouraged to continue their study of the whole area of currency gains and losses and in particular of questions relating to timing, characterization, attribution and source with a view to achieving international uniformity. They should be asked to use their best endeavours to discourage the characterization of currency gains and losses as deemed interest. Countries shall also bear this point in mind in any bilateral treaty negotiations.
2. (a) Where it still exists, the distinction between capital and revenue borrowings or loans should be removed
   (b) In determining currency profits or losses, losses should be attributed to and allowable in respect of those transactions to which they relate and accordingly no loss should remain unrelieved.
3. Actual exchange rates should be used to determine the value in the home country currency of dividends when paid and foreign taxes when suffered, provided no hardship is suffered as a result.
4. Governments and Revenue authorities should have regard to accounting standards and practices in developing laws and administrative rules in this field.
5. The importance of the imparity principle as being based on sound business practice should be recognised. Where currency hedging is involved, gains should not be taxed until both sides of the transaction have been completed. If such a concept cannot be reduced to statutory terms, the taxpayer should be permitted to make a series of irrevocable elections, whereby for timing purposes two or more transactions would be linked together.
6. For withholding tax purposes the amount of interest paid under an interest swap should be a single net amount and not the two gross amounts of interest.

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- Inkomstenbelasting 1964
  releases 523-527
- Investeringsregelingen.
  release 81
  Loonbelasting 1964
  release 353
- Omzetbelasting 1968
  releases 116, 117
- Vermogensbelasting 1964
  releases 100, 101

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ZfU-Zentrum für Unternehmungsführung: Managing a U.S.-subsidiary. Zürich, 17-19 November (English).

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International Bar Association: Trading with and Involvement in China. Brussels, 20-21 November (English).

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Legal Studies & Services Limited: The 1986 U.S. Tax Reform. Amsterdam, 24 November (English).

International Tax Planning Association: 1986 Seminar. Sydney, 24-25 November (English).

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DECEMBER 1986

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CUMULATIVE INDEX 1986 – Nos. 1-10

I. ARTICLES:

II. REPORTS AND DOCUMENTS

III. IFA NEWS

IV. CONFERENCE DIARY

V. BIBLIOGRAPHY

Contents

of the December 1986 issue

Alfred Bühler
Dr. iur. Dr. rer. pol.
1923 - 1986
In Memoriam

Dr. Alfred Bühler, the longtime Liechtenstein correspondent of the Bulletin, suddenly passed away in July 1986 at the age of 63. For many years he was an active member of I.F.A. He had an international law office in Vaduz. His clients from commerce and industry, some of which were operating multinationally, profited greatly from his knowledge of international taxation. His law office and his trust company will be continued by his associates.

He was also an eminent member of the Liechtenstein Bar. Through various publications in the field of corporate law he contributed to the development of Liechtenstein Law.

As a very good person and a strong personality he is very much missed by his family and associates.

INHALTSVERZEICHNIS

SOMMAIRE

40th Anniversary Edition

The Bulletin for International Fiscal Documentation celebrates its 40th anniversary with this December 1986 edition. Since its inception in 1938, the International Bureau of Fiscal Documentation intended to publish a periodical. In April of 1940 the first issue was ready in proof when the Netherlands were invaded. It would be five years before the Netherlands were liberated and another year before the Bulletin could be published.

The original intent of the Bulletin was to provide a forum for:

1. a general review of new fiscal legislation;
2. a general review of new fiscal jurisdiction, if of international importance;
3. a general review of new fiscal literature;
4. a review of treaties and conventions concluded between several states;
5. contributions relative to comparative law;
6. a list of new acquisitions of the Bureau's library;
7. a dictionary of fiscal law in 4 languages;
8. a review of the subjects on which the Bureau has given information; and
9. information published by the International Association for Public Finance and Fiscal Law.

During the past 40 years these goals have been achieved, although some of these through other publications and services of the Bureau.

European Taxation, for instance, provides up-to-date reviews of new European fiscal legislation, treaties and conventions concluded by the European States, and a "guest forum" for discussion of major topics of interest to the tax specialist.

The Bureau's library makes every effort to acquire all the latest books, periodicals and news sheets on taxation from whatever country, in whatever language. These new acquisitions, which are listed each month in the Bulletin, are circulated to the research staff and then placed on file. Any person interested in the use of the library, with 20,000 books on taxation and hundreds of fiscal and financial periodicals, is invited to visit the "Muiderpoort". The 4-language fiscal dictionary was abandoned many years ago. In its place the Bureau has developed a Tax Glossary (published in the Bulletin) containing definitions for all of the tax terms that have become known to the Bureau. A new edition is currently being completed.

The Bulletin rarely provides book reviews and has not published reviews of the subjects on which the Bureau has given information since the early issues. However, providing information on tax matters is an expanding task of the Bureau's information service for governments, tax advisors, accountants, multinational enterprises and individuals. The in-house staff of 25 lawyers and economists from 12 countries is prepared to answer questions of a factual nature for almost all the countries of the world. The information stored by the Bureau will soon be available to interested parties by computer.

The Bureau is now under new leadership and with this change the Bulletin is moving forward. Constant and constructive contact is being maintained with almost every nation of the world in order to identify new trends and important changes in taxation. With these intensified contacts the Bulletin is bringing the news more rapidly to the public forum. The Bulletin wants to be responsive to the needs of its subscribers. The editors of the Bulletin are interested in hearing the subscribers' comments concerning subjects that should be discussed.

Last month the Bulletin focused on transfer pricing. (The Bureau will be providing a loose-leaf service on this topic in the summer of 1987.) This month we are providing a major review of the harmonization trends of the European Community.

January will provide articles covering:

1. the Branch Profits Tax in the Tax Reform Act of 1986 (U.S.A.) by Dick Hammer and Bill Rohrer;
2. the Freedom of a State to Legislate in Fiscal Matters by Dr. Asif Qureshi;
3. the Treatment of Branches and Foreign Companies in Peru by Tomas O. Buckley, Carlos Enrique Llontop Chavani and Manuel Eduardo Francesqui;
4. the Nature of VAT, a review of VAT theoretically and in practice by J.C. Holland; and
5. the Major Features of Corporate Profit Taxes in Selected Developing Countries by Jitendra Modi.

With advanced computer facilities in the Bureau we expect to expand our coverage and deliver an even more applicable product to the subscribers. The Bulletin has provided the broadest, most in-depth and complete coverage of international tax developments for 40 years and, with your assistance, it shall continue to be the authoritative source for the international practitioner.

Sincerely yours,

D.A. van Waardenburg — Editor-in-chief

D.J. Olmstead — Managing Editor

Tax Harmonization in the European Community

By Sijbren Cnossen

I. INTRODUCTION

According to folk wisdom, people joined in matrimony tend to look more like each other as time passes by. There is a presumption that this should also happen to the tax structures of the member states of a common market, such as the European Community (EC). As barriers to trade and factor movements are broken down, individual economies become more closely integrated. As a result, the nature and size of the major tax bases should become more aligned and with it the various tax handles to which individual taxes are attached. Moreover, increased competition in product and factor markets may enhance rivalry in taxation. By definition, discriminatory border taxes, such as import duties, are prohibited in the Common Market. As border controls are further relaxed, effective product tax rates of adjoining states and, by extension, of the whole Common Market might move closer to the Community's average. Furthermore, differences in factor tax treatment should induce capital to move to countries with lower rates, which should act as a brake on too great a divergency in tax levels of individual Member States. Although differences in language and cultural traditions are important barriers, over time substantial differentials in the taxation of labor income might induce people to vote with their feet. Discretionary action, whether jointly or unilaterally, may accelerate these trends.

Against this background, this paper surveys and evaluates tax structure developments in the EC from its inception in 1957 until the present time. The second section looks at trends in the total level and overall composition of tax revenues. General contemporary influences have resulted in significant increases in tax burdens, particularly of the income taxes and social security contributions. The third section examines developments in the field of product taxes: the elimination of customs duties, the introduction of a common value-added tax, and the harmonization of excise duties. From the beginning, the fear of export subsidies or import taxes hidden in internal product tax systems has been of overriding concern in the Community. The fourth section reviews taxes on income and profits and social security contributions which have received much less attention, but which may become more important if equity and administration come to the fore as major areas of common concern. Finally, a concluding section considers the tax structure developments in the light of tax theory and attempts to place them in a broader social and political context. It argues that greater uniformity of tax systems is not necessarily conducive to the formation of a "good" community, just as closer resemblance in matrimony is not a litmus test for a happy marriage.

Tax revenue statistics, covering central, provincial, and local governments have been drawn from publications of the Organisation for Economic Co-operation and Development (OECD).[1] The term tax ratio is used to express tax revenues (including social security contributions) as a percentage of gross domestic product (GDP) at market prices, while the term tax share is defined as the percentage contribution of a particular tax to total tax revenues. Throughout the paper, brief references are made to the tax situation in the United States (U.S.) that has a comparable large market and that faces similar fiscal coordination issues as the EC. In 1983, the populations of the Member States of the EC totaled 320 million and their GDPs US$ 2,500 billion, yielding a per capita income of US$ 7,800. In the same year, the U.S. had 235 million inhabitants, its GDP was US$ 3,200 billion, and its per capita income US$ 13,600. Detailed data are shown in an Appendix.

Sijbren Cnossen is Professor of Taxation and Dean of the Economics Faculty of Erasmus University Rotterdam. This article is based on a paper presented at the International Seminar in Public Economics on *Tax Coordination in the European Community* held at Rotterdam, August 22-24, 1985. The author is editor of the Seminar's proceedings which have been published by Kluwer Law and Taxation Publishers, Deventer, The Netherlands. He is grateful to Emile a Campo, Ken Messere, Carl Shoup and other participants in the Seminar for their perceptive comments on an earlier draft of this paper. Whatever faults remain are his own.

Contents

1. For a note on the conceptual and practical pitfalls in making international comparisons of tax levels, see Messere and Owens (1985).

II. LEVELS OF TAXATION

Total tax levels have increased significantly in all Member States during the period under review. An examination of the overall composition of tax revenues indicates that this development is mainly attributable to increases in income taxes and social security contributions. References are made to explanatory factors for these trends.

A. Increase in total tax ratios

From 1955 to 1983, total levels of taxation in all EC Member States rose at historically unprecedented rates, as shown in Table 1. The weighted tax ratio for the EC as a whole increased from 29 to 40 in the period under review, or at an average rate of 0.4 percentage points per annum. By comparison, the tax ratio in the U.S. increased on average by 0.2 points per annum from 24 to 29, positioning it at the same level in 1983 as was the EC in 1955. In 1983, three EC Member States collected 45-47% of GDP in the form of tax revenue. In six other countries the ratio varied from 37 to 45. In later years, the tax ratio appears to be leveling off in the high-tax states (Messere, 1983). The figures suggest that the tax ratios of individual countries moved closer to the Community's average.[2] For three recent members – Greece, Portugal and Spain – that are distinctly less industrialized than most other states, the tax ratio was 33 or less in 1983, but the rate of increase since 1975 was greater than in other Member States.

Basically, as pointed out in the public finance literature, the reasons for the acceptance of high levels of taxation must be sought on the expenditure side of the budget, as epitomized in Wagner's law of the "expanding scale of state activity".[3] A detailed explanation of the underlying forces is beyond the scope of this paper, but some broad economic, social and political factors may be noted. Major upheavals, such as the two world wars and the great depression, interrupted the steady path of fiscal development and facilitated the acceptance of a larger role of the public sector (Peacock and Wiseman, 1961). Moreover, these events profoundly affected cultural values and social philosophies, resulting in, among other things, an increased effective demand for income redistribution through the budget. Following the last war, high levels of defense expenditures were replaced by increased public outlays on economic rehabilitation and, subsequently, transfer programs for the aged, sick, unemployed and other less privileged groups. No doubt, universal suffrage and the rise of participatory democracy strengthened these trends.

Table 1

EC: Total tax revenues as percentage of gross domestic product

Country[a]	1983	1975	1965	1955[b]	Tax buoyancy ratio[c]	Marginal tax ratio[d]
European Community[e]	*39.7*	*34.7*	*30.4*	*28.9*	*1.37*	*41.9*
Netherlands	47.3	43.6	33.6	26.3	1.50	50.5
Denmark	46.2	41.4	29.9	23.4	1.63	48.8
Belgium	45.4	41.1	30.8	24.0	1.59	49.1
France	44.6	37.4	35.0	32.4	1.31	45.9
Luxembourg	42.5	36.7	30.5	..	1.47	45.0
Italy	40.6	29.0	27.3	30.5	1.53	41.6
Ireland	39.2	31.6	26.0	22.5	1.54	40.1
United Kingdom	37.8	35.5	30.6	29.8	1.27	38.8
Germany	37.4	36.0	31.6	30.8	1.25	39.6
Greece	32.9	24.6	20.6	18.6	1.63	33.7
Portugal	32.9	24.7	18.4	15.4	1.83	33.6
Spain	27.2	19.6	14.7	..	1.91	28.0
United States	*29.0*	*29.6*	*26.3*	*23.6*	*1.13*	*29.7*

Notes: a. Listed in descending order of total tax revenue to GDP ratio in 1983.
b. Provisional estimates.
c. Percentage increase in taxes divided by percentage increase in GDP for the period 1965-83.
d. Increase in taxes divided by increase in GDP, expressed in percent for the period 1965-83.
e. Weighted averages.

Sources: Organisation for Economic Co-operation and Development (1985), Tables 3 and 113; 1955 figures for France and Greece: idem (1966).

A similar set of general contemporary influences has probably been at work on the tax side of the budget in the various Member States of the Community. The re-assessment of the role of the state involved the acceptance of higher levels of taxation than before. This and the effective spread of representative government made it possible to place greater reliance on taxpayer cooperation and voluntary compliance. Moreover, as economic development proceeded, the nature and accessibility of the various tax bases changed and with it the tax handles to which individual taxes are attached. Economies became highly monetized with virtually all income and output moving through the market. The size of production and distribution establishments increased and employment became more concentrated. At the same time, business accounting practices improved and government collection and assessment methods were modernized. Withholding techniques, of paramount importance for the successful administration of the income tax and social security schemes, were introduced in most countries. In short, the two major tax bases – income and consumption – could be broadened considerably and hence their revenue productivity increased. To be

2. The coefficient of variation (the standard deviation divided by the unweighted average, in percent) fell from 23.1 in 1965 to 15.7 in 1983. Broadly, the ranking in terms of total tax to GDP ratio altered little between 1955 and 1983. The Spearman coefficient is 0.685 with a significance at the 95% level. Weighted tax ratios are computed by converting absolute figures for tax collections and domestic products denoted in national currencies into figures denoted in U.S. dollars.
3. This and the following paragraph draw heavily on Musgrave (1969), Chapter 5. For a recent analysis of expenditure growth in industrial countries, see also Tanzi (1986).

sure, the emergence of large underground economies (Tanzi, 1982) may have helped to check these increases in some Member States.

As has been noted before (Goode, 1968), the feasibility of diverting a rising share of GDP to the public sector through taxation may be explained by the high rates of economic growth in the Community, particularly in the earlier years. As per capita income increased, nearly quintupling in nominal terms since 1965 (see Appendix), the proportion of income required for food and shelter diminished. Hence, it may be postulated, the "ability-to-pay" for public sector outlays increased. Table 1 shows two measures of the change in total tax revenue to GDP. First, the tax buoyancy ratio denotes the relationship between the percentage increase in total tax revenue to the percentage increase in GDP. This ratio is above 1 in all EC Member States. Particularly high figures are shown for the high-tax countries and the low-tax countries. Secondly, the marginal tax ratio measures the fraction of the increase in GDP absorbed by taxes. This ratio is particularly high in the high-tax states, but not in the low-tax countries.

The unprecedented increase in the size of the public sector in the EC has not been matched in the U.S. Whereas the weighted tax ratio in the EC was 16% ahead of the U.S. ratio in 1965, the difference had grown to 37% in 1983. This image is altered little when non-tax revenues are taken into account. The weighted non-tax revenue ratio for the EC was 4.8 in 1982 against 6.2 for the U.S.[4] If these ratios are added to the total tax revenue ratios, the weighted average public sector "burden" in the EC is one and a quarter times that in the U.S. Apparently, political resistance to public spending and heavy taxes and charges is stronger in the U.S. than in the EC. Lately, however, there is a growing awareness in the Community of the disincentive effects associated with excessively generous entitlement programs and high marginal tax rates, as well as the stimulus that high taxes give to underground economic activities (De Clercq, 1985; Tanzi, 1986; OECD, 1986a).

B. Overall composition of tax revenues

The time trend of economic, social and political forces sketched above may now be extended to broad categories of taxation: product taxes, income taxes, social security contributions, property and other taxes. Thus, the pervasive rise of egalitarianism has been a driving force behind the increased use of the progres-

4. In 1982, non-tax revenue ratios for individual Member States were – Ireland: 7.2; United Kingdom: 7.1; Denmark: 6.8; Netherlands: 6.7; Germany: 6.5; Luxembourg (1981): 6.0; France: 3.3; Greece: 3.1; Belgium: 2.6; Spain (1981): 2.3; and Italy: 2.0. In addition, of course, aspects such as the extent of tax expenditures (doing things through the tax side rather than the expenditure side of the budget), public borrowing and the effect of underground economies have to be taken into account in evaluating the size of the public sector.

Table 2
EC: Composition of total tax revenues

Country[a]	Product taxes			Income taxes			Social security contributions			Property and other taxes		
	1983	1975	1965	1983	1975	1965	1983	1975	1965	1983	1975	1965
	As percentage of Gross Domestic Product											
European Community[b]	*11.1*	*9.9*	*10.8*	*12.4*	*10.7*	*8.4*	*13.6*	*11.8*	*8.1*	*2.6*	*2.3*	*3.1*
Netherlands	11.4	10.5	9.6	13.0	15.2	12.0	21.3	16.7	10.3	1.6	1.2	1.7
Denmark	16.5	13.9	12.2	25.4	24.4	13.7	1.8	1.0	1.6	2.5	2.1	2.4
Belgium	12.0	10.9	11.4	18.6	16.1	8.5	13.9	13.1	9.7	0.9	1.0	1.2
France	12.9	12.3	13.4	7.9	6.6	5.6	19.6	15.3	11.9	4.2	3.2	4.1
Luxembourg	10.1	7.6	7.6	18.9	15.8	10.9	10.6	11.1	9.9	2.9	2.2	2.1
Italy	9.5	8.5	10.8	14.9	6.2	4.9	14.6	13.3	9.3	1.6	1.0	2.3
Ireland	18.1	14.7	13.7	13.0	9.5	6.7	5.8	4.4	1.7	2.3	3.0	3.9
United Kingdom	11.3	9.0	10.1	14.6	15.8	11.3	6.7	6.2	4.7	5.2	4.5	4.5
Germany	10.3	9.7	10.4	12.5	12.4	10.7	13.3	12.3	8.5	1.3	1.6	2.0
Greece	14.3	11.9	10.7	5.4	3.4	2.0	11.7	6.7	5.5	1.5	2.6	2.4
Portugal	14.4	10.1	8.2	8.1	4.3	4.5	8.5	8.5	4.0	1.9	1.8	1.7
Spain	6.5	4.7	6.0	7.1	4.3	3.6	12.2	9.3	4.2	1.4	1.3	0.9
United States	*5.2*	*5.5*	*5.8*	*12.4*	*13.0*	*12.2*	*8.3*	*7.3*	*4.3*	*3.1*	*3.8*	*4.0*

Notes: a. Listed in descending order of total tax revenue to GDP ratio in 1983.
b. Weighted averages.

Source: Organisation for Economic Co-operation and Development (1985): Table 24 (heading 5000); Table 8 (heading 1000); Table 14 (heading 2000); and the difference between the figures shown in Table 1 of this paper and the sum of the figures shown in this table for product taxes, income taxes and social security contributions.

sive income tax as the best available indicator of economic power and social status. Similarly, the growing sense of social responsibility for the welfare of individuals has resulted in greater reliance on social security contributions to finance related transfer programs. At the same time, these social and political factors should have diminished the relative role of product taxes whose burden distribution is generally perceived as regressive with respect to income.

Generally, this line of reasoning is borne out by the figures shown in Table 2. The weighted product tax ratio in the EC rose only slightly from just below 11 in 1965 to just above 11 in 1983. In view of the substantial increase of 31% in the overall tax ratio, this implies that the share of product taxes in total tax revenue declined. Substantial increases in the product tax ratio took place in Denmark (that has one of the highest tax buoyancy ratios of all Member States), Luxembourg, Ireland, and the low-tax countries, Greece and Portugal. As expected, the ratios of the income taxes and social security contributions rose markedly. For the income taxes, the weighted average ratio increased by 48%, and for social security contributions the increase was 68%; both figures are well above the rise in the overall tax ratio. For the income taxes, above average increases in the ratios were recorded in Denmark, Belgium, Luxembourg, Italy, Ireland, Greece, Portugal and Spain. In the Netherlands, Ireland, Greece, Portugal and Spain, revenues from social security contributions increased by more than 68%.

Table 3
EC: Importance of customs duties revenue

Country[a]	1983	1975	1965
As percentage of Gross Domestic Product			
European Community[b]	*0.5*	*0.6*	*1.1*
Portugal	1.4	2.4	3.8
Belgium	0.9	0.6	1.3
Greece	. .	1.4	2.2
Spain	0.7	0.8	1.0
Ireland	0.6	0.5	0.8
Netherlands	0.6	0.7	2.2
United Kingdom	0.4	0.5	1.0
Germany	0.4	0.4	0.7
Italy	0.3	0.1	0.7
Denmark	0.3	0.4	0.8
France	0.2	0.2	0.6
Luxembourg	0.1	. .	0.1
United States	*0.3*	*0.2*	*0.2*

Notes: a. In descending order of customs duties revenue to GDP ratio in 1983.
b. Weighted averages.
Source: Organisation for Economic Co-operation and Development (1985), country tables (heading 5123).

These trends were much less pronounced in the U.S. Although the ratio for social security contributions nearly doubled, it remained well below the EC average. Moreover, the income tax ratio rose only slightly and the product tax ratio dropped some 10%.

An issue which has preoccupied the Community from time to time (Neumark, 1963; Deringer, 1964; Fredersdorf, 1978) is the "proper balance" between direct and indirect taxes. (For this purpose, direct taxes are defined to include the individual income tax, the corporation tax, social security contributions from employers and employees, and various taxes on property; indirect taxes, on the other hand, comprise the value-added tax, excises, and customs duties.) As a closer economic union developed, it was argued, tax harmonization would be facilitated if Member States were to align their direct/indirect-tax ratios in the meantime. Direct-tax Member States should reduce their reliance on the income taxes and social security contributions, while indirect-tax states should put less emphasis on revenues from the value-added tax and excises. Whatever the merits of this line of thought, such a trend can hardly be discerned from Table 2. In 1965, the Netherlands, Luxembourg, the United Kingdom and Germany were direct-tax countries, in the sense that their direct-tax ratio exceeded the Community's (unweighted) average ratio. The first two countries had clearly maintained that status in 1983, but had been joined by Belgium, Italy and Spain.

III. COORDINATION OF PRODUCT TAXES

The formation of a true common product market was the most essential objective of the Treaty of Rome. This meant that the Community should ensure both the free movement of goods and equality of competition. Firstly, this involved the elimination of all remaining customs duties and the establishment of a common external tariff. Secondly, the complementary goal of equality of competition meant that Member States should not be allowed to use their internal product taxes, such as sales taxes and excises, to discriminate against goods from other Member States. To this end, unequivocal border tax adjustments based on the destination principle were required. But these adjustments implied that border controls could not be dispensed with forthwith, leaving the Community with the task of removing customs posts.

A. Abolition of customs duties

One of the foremost objectives of the Treaty of Rome was the creation of a true customs union in which all duties on imports and exports would be prohibited and abolished and a common customs tariff adopted with respect to third countries. Essentially, this goal was achieved in 1968, 18 months ahead of schedule, although, as discussed below, various infringements linger on. Not surprisingly, therefore, the revenue role of customs duties greatly decreased in the period under review. As shown in Table 3, the weighted ratio was halved between 1965 and 1983; the coefficient of variation decreased from 80% to 69%. In the latter year, on average, the duties contributed some 1% to total tax revenues. Above or below average ratios in some Member States simply mean that more or less external imports enter through them. The revenue role of customs duties in Portugal, Greece and Spain should decrease further as these countries' tariffs are harmonized with that of the Community.

The loss of revenue from the elimination of internal tariffs in the EC might have been made up by an increase in the common external tariff. This did not happen, however, because various general import duty reductions were negotiated among industrial countries under the auspices of the General Agreement on Tariffs and Trade (GATT), lowering tariff levels on non-agricultural goods from some 15% in the 1950s to about 5% now. As a result, the revenue role of customs duties in the EC and the U.S. moved closer together. In the industrial world, customs duties have become a minor source of revenue. In the EC, proceeds from customs duties collected by the Member States are paid into the common fund as they are considered part of the Community's "own resources", along with receipts from agricultural levies and a 1.4% charge on a uniformly determined value-added tax base (Council, 1972, as amended).

For the internal market, Article 3(a) of the Treaty requires the elimination not only of customs duties, but also of quantitative restrictions on the import and export of goods, and of all other measures having equivalent effect. The European Court of Justice, called upon to rule on this provision, has broadly interpreted the meaning of this clause. Thus, in Dassonville (Case 8/74), the Court declared that ". . . all trading rules enacted by member states which are capable of hindering, directly or indirectly, actually or potentially, intracommunity trade are to be considered as measures having an effect equivalent to quantitative restrictions." Derogations from the Article are to be construed strictly, i.e. subject only to those permitted under Article 36 for reasons of public morality, public policy, public security, and the protection of health. Similarly, strict interpretations have been accorded to the prohibition upon charges having an equivalent effect. Thus, the Court has declared invalid the imposition of various fees and charges for the issue of import licenses, unloading at borders, the compilation of statistics, and public health, phytosanitary and veterinary inspections carried out at internal borders upon imported or exported products.[5]

To be sure, Article 17(3) permits Member States to convert a customs duty formerly imposed for the purpose of raising revenue into a non-discriminatory excise tax on the same product, but even then the Court will look beyond its mere form and have regard to the substance of the new tax. For example, in Capolongo (Case 77/72), the Court ruled invalid the imposition of an excise tax on cardboard and cellulose containers, whether imported or domestically produced, the proceeds of which were paid into a public corporation that had as its sole purpose the promotion of the domestic production of such products. More generally, the Court has not taken a constructionist attitude to the prohibition of discrimination, but extended its authority beyond a literal examination of the national law, to the nature and economic effects of the tax, the actual characteristics of the product, the economic circumstances of a particular industry, as well as the uses to which the proceeds are put.

When in doubt, the Court has chosen to favor the imported product by ruling that it should not be taxed at a rate higher than the lowest rate applicable to a similar domestic product (Case 148/77). Furthermore in a number of cases (7/68; 51/74), the Court has ruled that Member States are not permitted to tax exports more heavily than goods destined for the domestic market.

Finally, a review of the various cases suggests that "the Court does not ever seem to have taken the view that an action which offends the Treaty becomes less offensive if it is widely practised" (Easson, 1980, para. 16).

B. Introduction of common value-added tax

The founding fathers of the Community clearly realized that the removal of tariffs, quotas, subsidies and other customs barriers would not create a truly common market, if Member States were allowed to maintain or restore through their internal tax systems the discriminatory treatment of trade with other members (Sullivan, 1967). In addition to the prohibition of customs duties, Article 95 therefore prescribes that "no Member State shall impose, directly or indirectly, on the products of other Member States any internal taxation of any kind in excess of that imposed directly or indirectly on similar domestic products." This provision reinforces the ban on customs duties, prohibiting the imposition of discriminatory taxes having the same effect (see above) and, more broadly, seeks to ensure conditions of free competition between Community products by removing distortions emanating from national tax systems.

As succeeding articles make plain, free competition of goods crossing intra-Community borders is sought to be achieved through the unequivocal application of the destination principle which holds that goods should be taxed at the rate prevailing in the country in which they are consumed rather than at that in the country in which they are produced (origin principle). To place imports on an equal tax footing as domestic goods, the destination principle entails border tax adjustments under which previously imposed taxes on exports are fully rebated and compensatory taxes are placed on imports equivalent to the internal taxes on domestic goods. As a result, internal taxes do not distort the relative costs between home-produced and foreign-made products. Hence, they are neutral with respect to manufacturing location decisions, an efficiency re-

5. For a detailed description and analysis on which these paragraphs draw, see Easson (1980), paras 9-23, and the literature cited there.

quirement that is one of the fundamental principles of the Treaty.

Non-discriminatory border tax adjustments could not be applied unambiguously under the cumulative turnover taxes that were levied in all but one of the six original Member States at the time the Treaty was signed in 1957, because the amounts of the export rebates and the compensatory import taxes depended not only on the rate of tax, but also on such unknown factors as the number of times a product had been traded and the amount of value added in various stages. Therefore, border tax adjustments had to be computed on the basis of estimated average rates that might incorporate protectionistic elements. To implement a proper system of border tax adjustments, Article 99 placed a mandatory call upon the EC Commission to submit proposals for the harmonization of turnover taxes, excises, and similar forms of internal taxation.

The harmonization of the various turnover taxes was pursued through the Community-wide adoption of a destination-based, tax credit type of value-added tax extending through the retail stage. The tax credit mechanism, permitting sellers a full credit for taxes invoiced by suppliers, ensured that export rebates could be ascertained unambiguously. Furthermore, the value-added tax treated imports in the same way as domestic goods by taxing the former at the same rate and allowing such tax to be offset against the tax payable in succeeding stages. In the case of registered traders, the effective tax rate would always be determined at the retail stage where imports and domestic products would be treated alike.

As shown in Table 4, 9 Member States introduced the common value-added tax between 1967 and 1973. Portugal and Spain followed in 1986 and the introduction date for Greece has been set for 1987. The value-added tax has become an important source of revenue, contributing on average 17% to total tax revenues, or 6.6% of GDP. The revenue role differs widely in various Member States ranging from 5.1% of GDP in Luxembourg which imposes a comparatively low standard rate of 12%, to 9.8% of GDP in Denmark which applies a high, single rate of 22%. The ranking of the tax ratios is not necessarily the same as that of the standard tax rates, because all Member States, except Denmark, also levy reduced and some increased rates of value-added tax on different categories of goods and services. Ireland, for example, has the highest standard rate, but its GDP ratio ranks third, because a broad range of goods and services are zero-rated, as is the case in the United Kingdom. Reportedly, in Italy which also has a high standard rate, a substantial part of the value-added tax is evaded (Pedone, 1981, p. 35). Judging by the increase in the spread of the standard rates, the once expressed goal of rate approximation has become more elusive. The coefficient of variation increased from 21.5 to 26.3.

Table 4
EC: Role of value-added taxes

Country[a]	Year VAT introduced	Standard VAT rate[b] 1986	Standard VAT rate[b] Year VAT introduced	Receipts as percent of Gross Domestic Product 1983	Year VAT+1	Year VAT−1	1965
European Community[c]	–	*17.1*	*12.6*	*6.6*	–	–	*4.6*
Denmark	1967	22	10	9.8	6.8	3.0	2.7
France	1968	18.6	16.7	9.1	9.7	8.2	8.1
Ireland	1972	23	16.4	8.3	5.1	4.3	1.5
Belgium	1971	19	16	7.6	6.9	7.4	6.5
Netherlands	1969	19	12	7.0	5.5	5.5	4.2
Germany	1968	14	10	6.4	5.7	5.0	5.2
Italy	1973	18	12	6.1	4.9	3.2	3.5
United Kingdom	1973	15	10	5.2	3.2	2.2	1.8
Luxembourg	1970	12	8	5.1	4.1	3.0	3.8
Greece[d]	–	–	–	5.0	–	–	2.3
Portugal[e]	1986	16	16	4.7	–	. .	. .
Spain[f]	1986	12	12	3.3	–	. .	3.3
United States[g]	–	*4-8*	–	*2.0*	–	–	*1.2*

Notes: a. Listed in descending order of value-added tax revenue to GDP ratio in 1983.
b. Rates are exclusive of value-added tax.
c. Weighted averages for GDP ratios.
d. Revenue figures refer to turnover and manufacturers sales taxes.
e. Revenue figures refer to previously imposed wholesale tax.
f. Revenue figures refer to previously imposed turnover tax.
g. Refers to retail sales taxes levied by 45 states and the District of Columbia.

Source: Organisation for Economic Co-operation and Development, *Revenue Statistics*, various years, Table 28 (heading 5100).

Table 5
EC: Importance of excise tax revenues

Country[a]	Total		Tobacco		Alcohol		Petroleum products		Other[b]	
	1983	1965	1983	1965	1983	1965	1983	1965	1983	1965
	As percentage of Gross Domestic Product									
European Community[c]	*3.2*	*4.7*	*0.8*	*1.4*	*0.5*	*0.7*	*1.6*	*1.9*	*0.2*	*0.5*
Ireland	8.0	10.2	1.7	4.1	2.6	2.9	2.7	2.5	0.2	0.1
Denmark	5.7	7.8	1.1	. .	1.1	. .	1.1	. .	1.1	. .
United Kingdom	4.7	6.6	1.2	2.8	1.2	1.7	2.0	2.0	–	–
Luxembourg	4.3	3.0	. .	. .	. .	. .	. .	. .	. .	. .
Italy	3.3	5.5	0.7	1.4	0.1	0.2	2.2	2.5	0.3	1.4
Germany	2.7	3.5	0.8	1.0	0.4	0.6	1.4	1.6	0.1	0.3
Netherlands	2.6	2.7	0.6	0.9	0.5	0.5	1.0	1.1	0.1	0.1
Belgium	2.4	2.5	0.7	0.6	0.4	0.5	1.2	1.3	0.1	0.1
France	2.4	3.8	0.3	0.7	0.3	0.2	1.5	2.0	0.2	0.8
United States	*2.0*	*3.3*	*0.3*	*0.5*	*0.3*	*0.7*	*0.3*	*0.7*	*0.8*	*0.8*

Notes: a. In descending order of total excise tax revenue to GDP ratio in 1983.
b. Excluding revenues from special excises on the purchase of automobiles (which are subject to higher value-added tax rates elsewhere) and user charges in Ireland, Denmark, United Kingdom, the Netherlands and the United States. However, these revenues are included in total excise tax revenues.
c. Weighted averages.
Source: Organisation for Economic Co-operation and Development (1985), country tables, headings 5121 and 5122.

It may be surmized that the value-added tax has become a mainstay of the revenue structures of various Member States, precisely because agreement has been reached on a uniform basis of assessment. Derogations from this basis are not permitted, implying that the tax base is not subjected to the usual national political forces of erosion. (Admittedly, Ireland and the United Kingdom still retain a zero rate for certain domestic products, but eventually this rate has to be phased out.) There is a weak presumption, therefore, that Member States may exploit the value-added tax base more fully than that of other taxes, thus enlarging the role and scope of their public sector. Some evidence for this proposition may be found in the increase in the average standard rate by 4.5 percentage points, or 36% of the average starting rate. Moreover, the weighted ratio of sales tax receipts to GDP since 1965 increased by 43%, well in excess of the increase in the total tax ratio of 31%. Although nearly all governments professed that the changeover to the value-added tax would be revenue-neutral, on average, revenues increased by 24% after the change.[6] The revenue role of the retail sales taxes that are levied in 45 out of 50 states (and the District of Columbia) in the U.S. is much more modest than that of the value-added tax in the EC.[7]

C. Excise tax developments

Developments in the excise tax field have been different from those of the value-added tax. As shown in Table 5, excise revenues decreased on average from some 5% of GDP in 1965 to about 3% in 1983. Ninety percent of such revenues derives from three products: tobacco, alcohol and mineral oil. The tobacco excise ratio dropped sharply, but the other two ratios decreased too. A similar trend occurred in the U.S., suggesting that some common influences have been at work. Awareness of the harmful effects of smoking has resulted in a decline of per capita tobacco consumption. Per capita consumption of alcohol, on the other hand, doubled in the period under review as social bans on drinking were relaxed and retail outlet policies liberalized (Cnossen, 1981). To cushion the effects of major price increases in mineral oil products, the real value of the related excises declined more sharply (Tait and Morgan, 1980). With the exception of part of the duty on cigarettes, most excises are specific. In the absence of periodic discretionary adjustments, therefore, inflation has eroded their real value. Furthermore, several EC Member States are major producers of wine, beer and spirits, creating political pressures to keep duties low.

Although Article 99 of the Treaty of Rome mentions excises in the same breath as sales taxes as prime candidates for harmonization, so far progress has been excruciatingly slow. A working party was established as early as 1960 and the Neumark Report (1963, p. 127) emphasized that excises should be harmonized in step with the sales tax, but it was not until 1972 that the EC Commission issued a framework-directive outlining the features of a possible harmonization policy. The Commission classified the excises in the Member States into four main groups:

6. For a view that the value-added tax did not necessarily increase government spending, see Stockfish (1985).
7. For a survey and analysis of sales taxes in OECD member countries, see Cnossen (1983c).

(1) Harmonized excises to be levied in all Member States on tobacco products, alcoholic beverages, and petroleum products; agreement on common definitions for the various bases of assessment should be followed by rate unification.
(2) Excises, e.g. on matches, playing cards, and gramophone records, to be incorporated in increased value-added tax rates, and thereby eliminated; of course, this begged the question of the eventual removal of border controls.
(3) Excises, e.g. on entertainment and betting, that might be retained because they do not involve border tax adjustments or affect trade between Member States.
(4) Excises to be abolished, because their contribution to revenue is negligible, because they are levied on products imported from developing countries (e.g. coffee), or because they are in large part a raw material for industry (e.g. sugar).

From the beginning, the concern has mainly been with the traditional excises on tobacco products, alcoholic beverages, and petroleum products (and related taxes on motoring). Since nearly all these products are processed in large manufacturing establishments that are integrated forward with the export stage, the application of proper border tax adjustments has not been a problem, but rather the focus has been on infringements of the non-discrimination principle of Article 95.[8] According to the Commission (1980, pp. 31 and 57), "the symbiotic relationship between national industries and national excises has resulted in excise structures that discriminate against products of other Member States." And in the same vein, real or feigned concern with national social and health policies "generally result in preferential treatment of domestic production."

Until a few years ago, for instance, France and Italy imposed substantially higher excises on spirits made from cereals, such as gin, whisky and vodka, than on spirits distilled from wine, such as cognac, armagnac and calvados. Since the cereal distillates were all imported, in effect the excise structures of these countries favored domestic products, although there was no open discrimination on the basis of origin. Similarly, Denmark had a separate rate for akqavit, which was taxed at only two-thirds the rate imposed on brandy, gin, rum and whisky, which were mostly imported. Upon complaints filed by the EC Commission, the Court of Justice (Cases 168-171/78) ruled that all these products stood in a competitive relationship to each other. Hence, the non-discrimination principle of Article 95 implied that the tax on an imported product could not exceed the tax on a comparable domestic product. In another case (55/79), it was held that Ireland discriminated against imported products by affording Irish producers preferential treatment with regard to the time limits for payment of the excises. The United Kingdom lost its case (170/78) against the Commission on the relative tax burdens to be imposed on wine and beer. The Commission took the view that the ratio of the two excises should not exceed that of the alcoholic strength of an average table wine and the most popular beer. This pointed to a ratio of 3 : 1, since table wine is typically 11% alcohol by volume and beer about 3.5%.

Although the Court's decisions may have eliminated the most obvious forms of discrimination, considerable differences continue to exist in the level and the structure of the various excises on alcoholic drinks. As shown in Table 6, duty levels are particularly high in Denmark, Ireland and the United Kingdom. Furthermore, Italy (and Greece) do not levy a wine excise at all and Germany confines its excise to sparkling wine. National vinicultures are further protected by rate structure distinctions between wine from fresh grapes and fruits, ordinary and fortified wines, and still and

8. For an analysis of the non-discrimination principle of Article 95, see Easson (1980), paras 23-66. For a description of excise tax harmonization, also paras 218-51.

Table 6
EC: Examples of excise taxes, March 1985

Member State	20 cigarettes[a]	1 liter of beer	1 liter of wine	0.75 liter of 40% spirits	1 liter of premium petrol
			In European Currency Units		
Ireland	1.14 (75)	1.14	2.74	7.84	0.36
Denmark	1.96 (87)	0.65	1.35	9.58	0.28
United Kingdom	1.25 (75)	0.70	1.60	7.70	0.29
Luxembourg	0.54 (67)	0.06	0.13	2.54	0.20
Italy	0.57 (72)	0.18	–	0.75	0.49
Germany	1.02 (74)	0.07	–	3.43	0.23
Netherlands	0.74 (72)	0.23	0.33	3.79	0.28
Belgium	0.73 (71)	0.13	0.33	3.78	0.25
France	0.31 (75)	0.03	0.03	3.37	0.36
Unweighted average	*0.92 (74)*	*0.35*	*0.93*	*4.75*	*0.30*

Note: a. Figures in parentheses indicate the proportion of excise and value-added tax in consumer price of the most popular price category of cigarettes.
Source: Commission of the European Communities (1985).

sparkling wines. In vain the Commission has attempted to reach agreement on common bases of assessment and collection, let alone the different rate structures. Basically, harmonization is still where it stood in 1972 when the Commission formulated as points of departure: (a) all Member States to impose some excise on wines; (b) spirits to be taxed on the basis of alcoholic strength; (c) both wine and beer to be taxed by volume (possibly at different rates within as well as between the two categories); and (d) tax on beer to be assessed at the product stage rather than on the wort which requires discretion in the taxation of imports.

More progress has been made with the harmonization of the various tobacco excises, possibly because most raw tobacco is imported, production is highly concentrated, cost differentials are small, and there is a widespread consensus on the harmful effects of smoking. Common definitions of manufactured tobacco products have been agreed upon (an important prerequisite for excise harmonization), as well as a phased reduction of the specific element (a fixed monetary amount per weight unit) in the excise (allegedly favoring expensive imported blond tobaccos), from 5-75% in 1972, to 5-55% in 1977, and further to 10-35% as proposed in 1980. Eventually a target ratio of 20% is envisaged, resulting in a predominantly ad valorem regime. But agreement will probably be hard to reach. The ratio of specific to total tax is 5 in southern EC-countries, but above 40 in most northern Member States. Here, tax principle and politics are clearly at loggerheads. Retail prices of representative brands of cigarettes differ considerably in the EC, but this should primarily be attributed to the differences in quality. Effective tax rates (defined as the sum of excise and value-added tax, expressed as a percentage of the tax-inclusive retail price) lie within the fairly narrow range of 67-75%, excepting Denmark (Table 5).

In contrast, progress in harmonizing the taxes on motoring has been very slow. The Commission has attempted in vain to reach agreement on a draft directive for a uniform basis of assessment for the fuel excises. Also it has submitted proposals to the Council of Ministers to eliminate any double taxation of motor vehicles, to standardize national systems of taxes on lorries, to exempt the temporary importation of certain means of transport, and to standardize the tax-free admission of fuel in fuel tanks. Thus far only the draft directive exempting 50 liters of fuel in motor verhicle tanks has been approved, although the harmonization of the excises on diesel oil and liquified petroleum gas, as well as the exemptions and special-purpose reduced rates applied in some Member States, is of special importance (Commission, 1980). Except in Italy and Luxembourg, petrol excises are fairly closely aligned in the EC, ranging from 0.23 ECU in Germany to 0.36 ECU in France and Ireland (Table 6).

The Commission has not issued any specific directives for the harmonization of the nuisance excises levied in various Member States: for revenue purposes (sugar, soft drinks), as proxies for taxpaying capacity (consumer durables, cosmetics), or as relics of the past (salt, matches, playing cards). Judged by their contribution to GDP, it is surprising that these excises have not been eliminated long ago; the yield of most does not exceed 1/10 of 1% of GDP. They might be harmonized spontaneously if border controls for the major excises were removed (Cnossen, 1983b).

D. Removal of border controls and non-tariff barriers

The abolition of customs duties, the adoption of a common value-added tax with appropriate border tax adjustments, and some small steps toward excise harmonization have had little, if any, effect on the removal of internal border controls. Customs posts, mainly engaged in collecting and rebating national taxes, still straddle nearly every internal frontier. As the Deringer Report (1964) prophetically observed more than 20 years ago: "On this basis, it will still be necessary in twenty years' time to open one's case between Emmerich and Arnhem, Wasserbillig and Trier, between Erquelines and Jeumont, between Strassbourg and Kehl, Ventimiglia and Menton, to prove to customs that one has not wrapped cigars inside one's pyjamas."

To prevent this prophecy from having another 20 years' validity, the EC Commission (1985) has recently submitted a White Paper with a large number of clear and concise proposals (together with a detailed timetable for action) for removing physical, technical, and fiscal barriers between the Member States. Fiscal barriers comprise the border controls to implement the border tax adjustments for the value-added tax and the excises. To eliminate these controls for the value-added tax, initially a deferred payment system is to be introduced under which export rebates are granted on the basis of documentary evidence and the collection of the compensatory import tax is shifted inland to the first production or distribution stage. In a following phase – marking a major departure from earlier insistence on the adoption of the origin principle – a Community-wide destination principle would be maintained by mutual recognition of each Member State's tax credits shown on exporters' invoices, balances being settled through a common clearing house. For the excises, border controls would become unnecessary by linking national systems of excise suspension.

If fiscal barriers are removed by shifting border tax adjustments to books of account and linking the bonded warehouse systems for excisable products in individual Member States, cross-border shopping would become advantageous if tax rates differed widely, especially between adjoining Member States. Some 40 million people in the EC live along intra-Community borders. The abolition of customs posts might have unacceptable revenue consequences, the Commission believes, if some approximation of rates were not achieved. With the exception of Denmark and Ireland, this should be possible if the revenue picture for the value-added taxes and the excises is considered jointly. Variations in the total yield of these two major indirect taxes are considerably smaller than variations in the yield of either tax category.

Costs having the same effect as customs duties would, of course, continue to divide the Community if different product regulations and standards for health or safety reasons, environmental or consumer protection, that effectively impede entry, are permitted to remain in place.[9] To remove these technical, non-tariff barriers, the Commission (1985) proposes to accept as the guiding principle that if a product is lawfully manufactured and marketed in one Member State, it should be allowed to be sold freely throughout the Community. Essential health and safety requirements should be harmonized, as well as industrial standards in the fields of technology and telecommunications, construction, and the production of foodstuffs. Furthermore, public procurement, which covers a sizeable part of each Member State's GDP, should be liberalized and the Community's restrictive policies on state aids vigorously enforced. Finally, physical barriers would be done away with through the implementation of the single administrative (customs) document, the coordination of immigration policies and the adoption of common public health standards, the liberalization of the transport quota system and the enforcement of common protective measures relating to terrorism, drugs and crime.

IV. COORDINATION OF INCOME TAXES

Although the founding fathers of the EC were concerned chiefly with the removal of competitive distortions in product markets, the free movement of persons, services and capital is also one of the fundamental aims of the Treaty of Rome. According to Title III, such free movement includes freedom of establishment, the abolition of restrictions on the movement of capital belonging to residents of other Member States and of discrimination based on the nationality or residence of persons or firms. It was recognized that, as with product taxes, differences in income taxes might distort competitive conditions. Therefore, Article 220 requires that Member States enter into negotiations with a view to abolishing any double taxation of residents and firms of other Member States. Furthermore, Article 221 provides that Member States shall accord nationals of other States the same treatment as their own nationals with respect to the participation in the capital of companies or firms.

As the Neumark Report (1963) stood at the beginning of the formation of an integrated product market, so the Segré Report (1966) stands at the cradle of the establishment of an integrated capital market. According to the Report, tax considerations should not influence the choice of investment location, or the choice between direct and branch investment. International double taxation of investment income, various tax incentives, and the differential treatment of non-resident and corporate investments were identified as the chief obstacles to the free movement of capital. Many of the recommendations of the Segré Committee Report were adopted in the Commission's (1967) "Programme for the Harmonisation of Direct Taxes". It envisaged the liberalization of capital movements, among others through the introduction of the same type of corporation tax, based upon broadly similar methods of assessment and rates. Beyond this, a single comprehensive individual income tax should be introduced which, however, would continue to differ from one Member State to another for a long time to come.

A. Approximation of corporation taxes

Table 7 shows the various corporation tax systems in the EC, related tax ratios, effective standard tax rates, the extent to which corporation taxes are integrated with individual income taxes, and dividend withholding rates. Since the Treaty of Rome, 7 Member States have introduced an imputation system that permits shareholders a partial or full credit (if local taxes are not taken into account) for the corporation tax that can be attributed to the dividends received by them. Three members – Luxembourg, the Netherlands and Spain – still regard the corporation as an entity entirely separate from its shareholders and consequently tax distributed profits again in the hands of shareholders (classical system). Like Germany under its imputation system, Portugal has a split-rate system under which a lower rate of tax is levied on distributed profits, and Greece's corporation tax permits a deduction for dividends from taxable profits, as is commonly done for interest. The United States has a classical system of corporation tax.[10]

In 1983, the weighted average corporation tax ratio was 2.6 in the EC, up from 2.1 in 1965. Apart from a possible relative rise in corporate profits and rate increases, several special factors may have influenced these developments. In the Netherlands, for instance, incorporation rules were substantially liberalized in 1970 and nearly half of corporation tax revenue derives from natural gas operations. The general rise in the ratios since 1975 contrasts with earlier research (Conrad, 1974) that concluded that corporation taxes were a declining source of revenue due to erosion of the tax base (tax incentives), increased capital-intensity of manufacturing (higher initial write-offs), and a shift in economies to service industries (larger wage bills). On the other hand, this trend is clearly observable in the U.S. where the corporation tax ratio decreased from 4.2 in 1965 to 1.6 in 1983, because of numerous special concessions to industry. The increased revenue importance of the corporation tax levied in various U.S. states was more than offset by the declining importance of the federal tax.

For imputation countries, corporation tax ratios differ widely in the EC, ranging from 1.4 in Denmark that

9. For an analysis of the various non-tariff barriers in the EC whose removal is desirable for completing the internal market, see Pelkmans and Vanheukelen (1986).
10. For a description and analysis of the various corporation tax systems in the EC and other industrial countries, see Cnossen (1983a, 1984). For an early treatment of the international implications, also Sato and Bird (1975), and for the classic analysis, McLure (1979).

Table 7
EC: Role of corporation taxes

Country[a]	Revenues as percent of GDP			Statutory tax rate[b,c,d]	Tax credit as percent of statutory tax rate[e]	Dividend withholding rate
	1983	1975	1965			
European Community	*2.6*	*1.9*	*2.1*			
A. Imputation System						
United Kingdom	4.1	2.2	2.2	52	39.6	0/15
Italy	3.8	1.8	1.9	40.5	34.2(100)	0/30
Belgium	2.7	3.0	1.9	45	49.9	15
France	1.9	2.0	1.8	50	50	0/25
Germany	1.9	1.6	2.5	63.3/46.7	64.1(100)	5/25
Ireland	1.5	1.5	2.4	50	42.9	0
Denmark	1.4	1.3	1.4	40	37.5	15
B. Other Systems						
Luxembourg	7.4	5.7	3.4	47.3	–	0/15
Netherlands[f]	2.9	3.4	2.7	43	–	0/25
Spain	1.3	1.4	1.4	35	–	10/18
Greece[g]	0.8	0.9	0.4	48.5	–	25/42
Portugal	..	..	..	52/40	–	10/15
United States[f,h]	*1.6*	*3.2*	*4.2*	*50.3*	–	*30*

Notes: a. Listed in descending order of corporation tax revenue to GDP ratio in 1983.
b. In computing the total standard rate:
(i) local corporation tax rates (on an average basis if differentiated) are included in Germany, Italy, Luxembourg, and the United States;
(ii) surcharges or surtaxes are included in Italy, Luxembourg, and Portugal;
(iii) the statutory tax-exclusive local tax rates in Germany and Luxembourg have been converted to tax-inclusive rates as follows: $t_i = t_e/(1+t_e)$ where t_i is the tax-inclusive rate and t_e the tax-exclusive rate;
(iv) local taxes on corporate profits are deductible in computing taxable profits for the national corporation tax in Germany, Italy, Luxembourg, and the United States; the effective total corporation tax rate then equals $t_s(100-t_i)+t_i$ where t_s is the statutory national tax rate and t_i the (effective) tax-inclusive local tax rate.
c. Some countries levy higher corporation tax rates on specified mining (petroleum) companies (Netherlands, Spain), higher rates on non-resident companies (Belgium), or lower rates on manufacturing and processing operations (Ireland).
d. Lower corporation tax rates on small profits or, sometimes, small corporations are levied in Belgium, Ireland, Luxembourg, Portugal, the United Kingdom, and the United States.
e. Figures in parentheses indicate tax credit percentages without taking account of local taxes.
f. The Netherlands, France, and the United States exempt a small amount of dividend income in the shareholder's hands.
g. At the shareholder's option, dividend income is exempt.
h. In addition to the regular corporation tax, a tax of 15%, called an add-on minimum tax, is imposed on preference items.
Sources: Organisation for Economic Co-operation and Development (1985), Table 12; Cnossen (1984); and Berger (1985).

levies a low rate of 40% on company profits, to 4.1 in the United Kingdom where the rate is 52%. In comparing these ratios with those of other systems of corporation tax, it should be noted that the yields of the imputation systems include the creditable "income tax portion", whereas other systems, of course, leave the income tax out of account. Substantial differences exist also in the rates of tax credit permitted under imputation systems, ranging from 34% of the corporation tax rate in Italy to 64% in Germany. Similarly, withholding rates on distributed profits differ widely.

Although the corporation tax is not a major source of revenue in any EC Member State, even corporations that pay little or no tax are still subjected to all its complexities, attendant compliance costs and excess burdens, causing a substantial misallocation of resources in Member States themselves, as well as throughout the Community. Evidence for this may be found in a recent study (Kopits, 1982) dealing with factor prices in industrial countries. Based on 1978 data, the study estimated that "required" rates of return, which incorporate the effects of inflation and interest rates, ranged from a low of 5% in Italy to almost 18% in Germany. These figures indicate that the need to coordinate the systems of taxing company profits and distributions, as well as the removal of various non-tax barriers, are at least as important as in the case of the sales taxes and excises (also Neumark, 1963).

In line with its 1967 Programme, the Commission directed its attention first to the choice of the most appropriate type of corporation tax, focusing specifically on reducing the so-called economic double taxation of dividends arising under the classical system, and the coordination of the systems of withholding tax charged on dividends. In 1975, the Commission issued a draft directive calling for the adoption of an imputation system with a normal, single rate of corporation tax ranging from 45% to 55%, together with a 45-55% income tax credit on grossed-up dividends. Whether directly or through a subsidiary, source countries should extend their tax credit to shareholders in other Member States and bear its cost through a so-called clearing-house mechanism. Furthermore, dividend withholding tax rates were to be set at a uniform rate of 25%. The draft directive got stranded in the European Parliament (1979), however, which argued that it made little sense to harmonize corporation tax rates and the tax treatment of profit distributions as long as, possibly large, differences in the rules for computing taxable company income continued to exist between Member States. This will be the subject of a White Paper which the Commission intends to publish shortly.

B. Individual income taxes

For reasons broadly explained earlier, the role of the individual income tax in the tax structure of the various Member States has greatly increased in importance in recent decades. As shown in Table 8, the weighted average income tax ratio rose from 6.4 in 1965 to 9.8 in 1983, or by 53%. Apart from the wide acceptance of income as the most equitable tax base, various administrative and technical reasons account for the prominent place of the income tax. Thus, the universal expansion of wage withholding schemes in conjunction with the concentration of employment in larger and better organized production units has made PAYE the mainstay of income tax revenues. Like the value-added tax, the income tax has become less visible, reducing taxpayer resistance. In the Netherlands, for instance, wage withholding now accounts for 82% of income tax collections against 49% in 1965.

Furthermore, as pointed out by Messere (1983), the sharp rise in the income tax ratio between 1965 and 1975 should probably be attributed to uncorrected fiscal drag. With incomes growing in real terms, taxpayers were pushed into higher brackets. This effect was exacerbated by inflation which lowered real income brackets and eroded the real value of tax allowances. The income tax ratio has also been pushed up by a switch in aid to families from tax allowances to cash transfers, as well as by limitations in various Member States on the deductibility of mortgage interest, especially for second homes. From 1975 onwards, on the other hand, the upward effect of inflationary fiscal drag was substantially offset by automatic rate adjustments (indexation) and discretionary changes in most Member States, except Italy and to a lesser extent Belgium and Spain (OECD, 1986c). Similarly, the switch from joint to separate taxation of two-earner couples may have slowed down the increase in the ratio. Last but not least, the increase in social security contributions, which in most Member States are deductible in computing taxable income (Table 9), must have acted as a brake on the rising income tax ratio.

Even a perfunctory glance at one of the tax summary handbooks issued by various accounting firms indicates that the determination of taxable income and the rate structures that are applied differ greatly from one Member State to another. Numerous special allowances and credits exist for small and unincorporated firms. Capital gains, not arising in the course of business, either are not taxable or are subject to a preferen-

Table 8
EC: Role of individual income taxes

Country[a]	Revenue as percent of GDP			Effective tax rate 1984[b]		Rate band 1983
	1983	1975	1965	Single people	Two-child family	
European Community[c]	*9.8*	*8.8*	*6.4*			
Denmark	24.0	23.1	12.4	39.6	33.8	14.4 - 39.6
Belgium	15.9	13.1	6.3	21.4	13.6	17 - 72[d]
Ireland	11.6	8.0	4.3	25.9	15.6	25 - 65
Luxembourg	11.6	10.1	7.6	17.3	2.6	12 - 57[d]
Italy	11.3	4.4	3.0	17.4	14.0	18 - 65
Germany	10.6	10.8	8.2	17.6	10.7	22 - 56[d]
United Kingdom	10.5	13.6	9.1	22.1	17.6	30 - 60
Netherlands	10.1	11.8	9.3	11.8	9.3	17 - 72
France	6.0	4.6	3.7	7.7	0.0	5 - 65[d]
Spain	5.8	2.8	2.1	13.4	8.9	15.72 - 65
Greece	4.3	2.3	1.5	3.3	1.7	11 - 63.4[d]
Portugal	..	..	..	7.1	6.0	4 - 80
United States	*10.8*	*9.8*	*8.0*	*22.9*	*15.2*	*11 - 50[d]*

Notes:
a. In descending order of income tax revenue to GDP ratio in 1983.
b. Imposed on average earnings of an adult full-time production worker in the manufacturing sector after making allowance for standard tax reliefs unrelated to the actual expenses incurred by taxpayers.
c. Weighted averages.
d. Countries with zero-rated first brackets.

Sources: Organisation for Economic Co-operation and Development: (1985), Table 10; (1986a), Table 1; and (1986b), Table 1.10.

Table 9
EC: Role of social security contributions

Country[a]	Revenues as percent of Gross Domestic Product								Effective rate employees' contribution 1984[c]	Deductible from income.
	Total		Employees		Employers		Other[b]			
	1983	1965	1983	1965	1983	1965	1983	1965		
European Community[d]	*13.6*	*8.1*	*4.5*	*2.7*	*8.2*	*4.9*	*1.0*	*0.5*		
Netherlands	21.3	10.3	9.4	5.1	8.4	4.2	3.5	1.0	27.4	Yes[e]
France	19.6	11.9	5.2	2.3	13.0	8.9	1.4	0.7	14.8	Yes
Italy	14.6	..	2.9	..	10.4	..	1.3	..	9.5	Yes
Belgium	13.9	9.7	4.8	2.7	7.9	6.3	1.2	0.7	12.1	Yes
Germany	13.3	8.5	5.9	3.7	7.2	4.6	0.2	0.2	16.8	Yes[f]
Spain	12.2	4.2	2.4	1.0	9.1	3.2	0.7	–	6.0	Yes
Greece	11.7	..	5.0	..	5.0	..	1.7	..	13.2	Yes
Luxembourg	10.6	9.9	4.5	3.6	5.5	5.7	0.6	0.6	12.2	Yes
Portugal	8.5	4.0	3.3	1.6	5.0	2.4	0.2	–	11.5	Yes
United Kingdom	6.7	4.7	3.1	2.2	3.5	2.3	0.1	0.2	9.0	No
Ireland	5.8	1.7	2.1	0.8	3.7	0.9	–	–	8.5	Fixed
Denmark	1.8	1.6	0.9	1.1	0.9	0.5	–	–	5.5	Yes[g]
United States	*8.3*	*4.3*	*3.2*	*1.7*	*4.9*	*2.5*	*0.2*	*0.1*	*6.7*	*No*

Notes: a. In descending order of social security contributions to GDP ratio in 1983.
b. Self-employed or non-employed and unallocable receipts. Does not include voluntary contributions to government and/or compulsory contributions to the private sector. See Part C of OECD (1985) on the financing of social security benefits.
c. Expressed as a percentage of gross earnings of two-child families. This percentage is the same as for single people, except in Denmark (6.2) and Greece (13.3).
d. Weighted averages.
e. Except health insurance contributions.
f. Subject to a ceiling.
g. If within heading 2100 of OECD classification.

Sources: Organisation for Economic Co-operation and Development: (1985), Tables 16 and 18; (1986a), Table 3; and (1986b), Table 1.6.

tial rate. Furthermore, there are substantial differences in various deductions and personal allowances, the aggregation or separate taxation of family income, the initial and maximum rate of tax, and the comparable income brackets to which they are applied (for a full treatment, see OECD, 1986b). Consequently, the effective tax rate applicable to a single person earning the average industrial wage of a Member State may range from as little as 3% of his earnings in Greece to nearly 26% in Ireland.[11] Similarly, when deductions are made for family benefits, a married couple with two children may pay no tax in France but 18% in the United Kingdom. Not surprisingly, income tax ratios range from 4 in Greece to 16 in Belgium.

In view of the overriding concern with ensuring the free movement of goods and to a lesser extent capital, the harmonization of the individual income tax has received far less attention than the proper coordination of the product taxes and the corporation tax. To be sure, various committees (e.g. Neumark, 1963) have advocated the introduction of a similar type of global income tax with a similar bracket structure (but not similar rates) and in its "Programme for the Harmonisation of Direct Taxes", the Commission (1967) envisaged a single comprehensive personal income tax, but in the same breath it was stated that such a tax would differ from one Member State to another for a long time to come. Apparently, considerations of competitive distortions on account of wage-tax-induced labor costs, the free movement of workers and executives, as well as the requirements of a free capital market, did not feature as prominently in the income tax field as in other areas of taxation. More recently, the Fredersdorf Report (1978) concluded that it was not essential to harmonize the income tax. More fundamentally, Burke (1979), then a member of the Commission, stated: "it is not our ambition to harmonise the personal income tax in general, which is an important instrument of national policy and should be left to the Member States even when the Community achieves a much higher degree of integration than at present."

However, a notable exception has always been made for the (wage) income tax of frontier and migrant

11. The effective tax rate is 40% in Denmark, but since this country in effect has integrated the social security contributions with the income tax, the figure is not comparable with those in other Member States.

workers. Although double taxation both in the resident state (where the employee would have his home and family) and the source state (where he derives income from employment) is generally avoided under tax agreements, troublesome questions remain with respect to the (non-)aggregation of income, applicable rates, deductions and allowances. Various cases, for instance, Sotgiu (Case 152/73), involving the denial of allowances for non-resident family members, have been referred to the European Court of Justice which has considered that a rule based upon residence may conceal a discrimination based upon nationality. But granting an allowance to a non-resident worker may involve a double concession if the same allowance is extended by the resident country. Generally, full taxation in the resident country with a credit for tax paid in the source country would be the solution.

C. Social security contributions

Revenues from social security contributions rose as sharply between 1965 and 1983 as revenues from the individual income tax with which they are usually closely associated. The base on which both levies are imposed is often the same. Generally, employees' social security contributions are withheld along with the wage tax that forms a prepayment for the income tax. The major difference between the two levies concerns the rate structure and the assumed tax burden distribution. Social security contributions are payable on the first unit of earnings. Based on the insurance philosophy, moreover, rates are usually proportional and vanish beyond a prescribed income ceiling.[12] Ignoring benefits, therefore, the burden distribution should be regressive.

As shown in Table 9, the weighted average ratio of total social security contributions in the EC was 13.6 in 1983. This is nearly 40% above the average income tax ratio of 9.8. The Netherlands and France, which adhere strongly to the insurance view, collect some 20% of GDP in the form of social security contributions. In Ireland and the United Kingdom, on the other hand, ratios are respectively 6 and 7. In Denmark, contributions are virtually indistinguishable from the individual income tax with which they are nearly fully integrated.

Employers' contributions, usually significantly higher than employees' contributions, have increased at a somewhat greater rate than employees' contributions, possibly because they are even less visible and their incidence is even more uncertain. Employers' contributions are particularly high in Italy and France where they account for over 40% of the wage bill for an average worker (OECD, 1983). As a percentage of gross earnings, employees' contributions range from 6% in Spain to 27% in the Netherlands (Table 9).[13]

Although the Treaty of Rome envisages some approximation of social policies and the Commission's "Social Action Programme" (1974) mentions social security contributions and the benefits they are meant to finance, generally harmonization of the various systems is not perceived as necessary or considered feasible at the present stage. The issues involved are probably even more intractable politically than in the case of the individual income tax. Again, an exception has been made for the taxation of social security benefits of frontier and migrant workers. To ensure that they are treated the same as residents, the Community has attempted to provide for the aggregation of qualifying periods and for the payment of benefits to persons anywhere in the Community. Double taxation is avoided under bilateral agreements.

D. Removal of non-tax barriers

The Commission (1985) believes that the economies of scale offered by a large common market cannot be reaped readily if various obstacles to industrial cooperation remain in place. National laws and administrative practices hamper the development of cross-border activities by companies of different Member States. For this purpose, the European Economic Interest Grouping, governed by Community legislation, is being set up and a proposed statute for a European Company has been put up for a Council decision. Furthermore, national legislation on limited companies will be coordinated and the legal position of branches and subsidiaries clarified. The acquisition of holdings in companies in other Member States and cross-border mergers are to be facilitated. In turn, of course, these proposals have tax aspects that may well be the most important obstacle to eventual agreement. So far anyway, fear of revenue loss, either directly or through emigration of companies to lower-tax Member States, have stalled progress.

In the Commission's view, the liberalization of financial services would be a necessary adjunct to achieving greater industrial cooperation and integration. "Financial products" provided by the banking and insurance sectors should move as freely as "physical products". Harmonization measures in this area should be based on the principle of "home-country control", but standards of financial stability, accounting rules, and rules of supervision should be coordinated. Similar coordinating activities are developed in the areas of securities, savings contracts, consumer credits, etc. Beyond this, measures are planned to open up new service areas in information marketing and audiovisual services.

Nearly complete free movement of employees has already been achieved. Only government posts may be reserved for nationals. However, cumbersome administrative procedures relating to residency permits are still in effect and the rights of establishment for the self-employed are constrained by wide differences in vocational and professional qualifications. For universities the mutual recognition of degrees and diplomas

12. For arguments that most industrial countries have moved away from the insurance principle to the perception that contributions are just another tax, see Messere (1983).
13. See footnote 11.

is envisaged. The mobility of students will be promoted through the establishment of a Community scholarship scheme.

V. SUMMARY AND EVALUATION

In conclusion, there remains the question of evaluating the EC's efforts to coordinate and harmonize the tax systems of its Member States in the light of the theory of tax coordination and assignment and the special institutional context in which the Community takes shape.

A. Summary of survey

This paper has shown that the role and scope of the public sector in the various Member States of the EC is very large indeed. The weighted total tax ratio averages 40% of GDP. If non-tax revenues and other sources of finance are taken into account, on average, close to half of the Member States' income may be allocated through the budget mechanism. As recognized in the Treaty of Rome, these figures emphasize that it is clearly to the mutual advantage of the Member States to agree on common tax rules for efficient trade and factor utilization and fair entitlement of revenues. Such rules become more urgent as the EC moves closer to a confederation, a joining of independent jurisdictions for limited common purposes, including the completion of the Common Market and beyond that the creation of a monetary and economic union.

Substantial progress has been made in coordinating various product taxes. Customs duties have been abolished, some remaining quantitative restrictions are being phased out, and charges having an equivalent effect are prohibited. Furthermore, a destination-based common value-added tax with appropriate border tax adjustments has been introduced. Little progress has been made in the excise field, but some forms of blatant discrimination have been prohibited by the European Court of Justice which is increasingly establishing itself as a truly supra-national institution. Possibly substantial non-tariff barriers that may be compared to charges having equivalent effect as customs duties remain. Technically, however, it should be possible to remove border controls fully by shifting border tax adjustments for the value-added tax to books of account and by providing for a Community-wide system of excise suspension. As evidenced by the enormous growth of intra-Community trade, substantial progress has been made towards the objective of the free movement of goods based on the principle of non-discrimination.

There is little, if anything, to report on the coordination of the income taxes and social security contributions. Source Member States cling to their traditional rights to fully tax the profits of foreign-owned corporate activities. Substantial differences in the computation of the tax base, the rate structures, and the degree to which the corporation tax is (not) integrated with the individual income tax of shareholders remain; they should distort capital movements. Tax liability for the individual income tax is based on residence and rates are applied to a global income concept without, however, tax administrations in different Member States being able effectively to reach income earned abroad. There are many practical problems in processing exchanges of information and a common stand on the treatment of income arising outside the Community has not been developed. Generally, the same applies to social security contributions. Infringements on tax neutrality between Member States are largely ironed out through bilateral agreements for the avoidance of double taxation and special arrangements are hammered out for frontier and migrant workers.

Clearly, the founding fathers of the EC were foremost concerned with the removal of competitive distortions in product markets. In their view these were caused by indirect taxes which therefore should be harmonized in the interest of the Common Market. Apparently, the eventual removal of border controls as the most visible indication that the Common Market did not have the characteristics of a domestic market was foremost in their minds. To be sure, the free movement of capital and persons is also an explicit objective of the Treaty, but the approximation of the relating direct taxes is required only to the extent that they directly affect the establishment or functioning of the Common Market. The distinction between direct and indirect taxes that was made may have been influenced by naive views on incidence and the belief that distortions in factor markets would not affect product markets.

B. Theory of tax coordination and assignment

As Musgrave (1983) points out, the wish or necessity to establish intra-Community rules of good tax manners arises from the contingency to deal with tax burden exports and tax base flights. In the absence of an operational framework for basing taxes on the benefit principle (they would then represent cost-reducing payments for intermediate goods supplied by government), two criteria may be postulated for tax coordination. The first basic rule, deeply anchored in the Treaty of Rome, is tax neutrality: Member States should (re-)arrange their tax systems in such a way that the free flow of trade and factors is not distorted. More positively, tax coordination and harmonization is required for "creating a more favourable environment for stimulating enterprise, competition and trade" (Commission, 1985). The second, and really prior, requirement, to which much less thought has been given, is that entitlements to, or property rights in, tax bases should be established, based on the allegiance or residency principle, and the territoriality or source principle. To be sure, trade-offs must be made and administrative considerations should be taken into account.

Based on Musgrave's criteria of efficient resource mobilization and fair entitlement, the following principles of tax coordination and assignment, modified to suit EC arrangements, may be formulated.

(1) In analogy to the case for free trade, Community welfare was promoted following the abolition of import and customs duties between Member States and the establishment of a common external tariff. This prevents tax burden export, made feasible if the demand and supply for traded goods is inelastic and exchange rates are fixed. Moreover, there is a strong case for allocating the import tax base or the proceeds from import duties to the Community. Harmonized import duties imposed and retained by the Member State through which goods enter the Community would give rise to inefficiencies in resource utilization. Of course, some destination-based inter-treasury transfer system would also achieve tax neutrality, as do present arrangements under which import duties are collected by national customs administrations, but remitted to the Community. Eventually, a common customs service operating only at external frontiers may be envisaged.

(2) In view of the very high tax rates, the case for harmonizing the excises on tobacco products and alcoholic beverages is also urgent if border controls are to be abolished. Arguably, the proposed common customs service might also be charged with the administration of these major excises as Community sources of revenue. Linking systems of excise suspension seems to require close control of retail outlets which may not always be feasible. As regards oil and natural gas deposits, thus far Member States have jealously guarded their patrimony (as have U.S. states). In the EC, tax-inclusive export prices are permitted, provided owner Member States charge their own consumers and producers the same tax-inclusive price. Therefore, inefficiencies in the provision of public services financed by the additional revenues are accepted.

(3) Tax neutrality requires that relative prices between home-produced and foreign-made goods should not be distorted, establishing the case for precise border tax adjustments under the various value-added taxes. When border controls are abolished, some inter-treasury clearing-house arrangement is necessary if the destination principle is retained. To minimize tax base flight through cross-border shopping, some approximation of the value-added tax rates of adjoining Member States would be desirable and use taxes on (registered) durable consumer goods may have to be introduced. But as evidenced by the experience with state and provincial retail sales taxes in the U.S. and Canada, there is no compelling reason why the sales tax base should be ceded to the Community.

(4) Less coordination is required for those tax bases that have low intra-Community mobility. Taxes on employment income, representing by far the largest share of total income, are inherently less open to tax base flight and burden export than import duties and excises. Mobility is restrained by language and cultural barriers, which largely coincide with territorial borders. This applies not only to the wage income tax, but also to social security contributions. However, efficiency losses may occur to the extent that such taxes affect product prices. Furthermore, tax burdens may be imported if, in the absence of nationality requirements, the poor move to countries with generous social security benefits. In analogy to cross-border shoppers, special arrangements are required for frontier and migrant workers.

(5) Since the capital base is highly mobile, special coordination efforts are required in the field of corporation taxes and capital income covered by individual income taxes. Distorting location effects of tax differentials between Member States would be avoided under the allegiance (residency) rule, but, as Musgrave (1983) points out, for this approach to be effective, it must be assumed that Member States are in fact able to reach the income and profits of their residents in other Member States. If not, the territoriality principle has to be used, but to secure Community-wide efficiency in the location of resource use, it is then necessary to require uniform bases of assessment and rates across Member States. This is increasingly being appreciated with respect to the corporation tax.

(6) No such in rem solution is available for personal income taxes with progressive rates. A comprehensive personal tax can be pursued under the allegiance rule only if all income can be reached effectively and a full credit is given for all income taxes paid in other Member States. But this implies a full exchange of information pertaining to income tax liabilities and compliance control at Community level, so close that the contours of a central tax administration emerge. Moreover, the non-wastable foreign tax credit means that capital-exporting states are held hostage by capital-importing states. The requirement of a Community-level personal income tax becomes more urgent if the corporation tax is to be integrated with the income tax. In the absence of a central tax administration, the base of the personal income tax will not be truly global and it will not be possible to use the tax to secure inter-individual redistributional objectives on a Community-wide basis.

(7) Little, if any, coordination is required for benefit taxes and user charges that are closely attached to residency and territoriality characteristics. In view of the inherent immobility of the base, this is also true of property taxes.

Judging by the theory of tax coordination and assignment, the Commission's tax harmonization efforts seem to be on the right track. Technically, border controls can be removed without substantial further adjustments to the various indirect tax systems. A genuine single product market without internal customs posts is within reach and the main focus should be shifted to the removal of non-tariff barriers, such as regulations and standards, government procurement policies and subsidies. Furthermore, as indicated by the Commission's activities, the closer alignment of company tax burdens to ensure fair competition and eliminate tax-induced capital movements is rightly given high priority. Coordination of wage income taxation and social security contributions, as well as progressive income taxation, if really desired, might be left to a later stage, following the creation of a monetary and economic union. In the meantime, work should proceed on the approximation of legal requirements and licensing procedures.

C. Concluding remarks

As the Commission (1980) recognizes, tax sovereignty is one of the basic components of national sovereignty. Difficulties in the field of tax harmonization are compounded by deep-rooted differences in economic and social structures, different perceptions on the role of taxation, differences in the acceptability of various taxes, the technical complexity of tax harmonization, and complications arising from further enlargement of the Community. These difficulties are magnified as national monetary policies become more closely aligned, thereby increasing the weight on tax (and expenditure) policies for short-term stabilization and long-term structural adjustments in individual Member States.

More generally, differences in tax systems did not come about at random, but rather reflect social and political preferences that should not be ignored. It may be that after the removal of border controls, the introduction of a destination-based clearing mechanism for rate-differentiated value-added taxes and excises, and the approximation of the various corporation tax systems, the EC tax coordination process has been carried as far as it should go. Individuals in Member States are entitled to their national identity, cultural values, and the desire to spend as much of their own tax revenue on national goals, including redistribution, as they see fit. The Member States are in no sense the creation of the Community, but rather should retain at least as independent an existence as the Community seeks to achieve.[14] Under this view, efficiency losses, likely to be borne anyway by the Member State incurring them, may be an acceptable price to pay for retaining national diversity and autonomy. It is this new sense of realism that is the distinguishing characteristic of the latest Commission's White Paper (1985), which repeatedly asserts that the general thrust of the Commission's approach will be to move away from the concept of harmonization, understood as uniformity, towards that of mutual recognition and equivalence.

14. For an excellent review of recent thinking on issues of federal finance suggesting that the process of reaching decisions is as important as or possibly more important than their substance, see Bird (1984).

APPENDIX

European Community and United States:
Gross Domestic Product, population and per capita income, 1983 and 1965

Country[a]	Gross Domestic Product (In billions of U.S. dollars)		Population (In millions)		Per capita income[b] (In U.S. dollars)	
	1983	1965	1983	1965	1983	1965
European Community	*2,483.8*	*458.8*	*320.4*	*293.3*	*7,752*	*1,564*
Germany	653.1	114.8	61.4	58.6	10,633	1,959
France	516.3	97.9	54.4	48.8	9,486	2,007
United Kingdom	454.9	100.3	56.4	54.3	8,069	1,846
Italy	352.8	62.6	56.8	52.0	6,209	1,204
Spain	158.8	23.3	38.2	32.1	4,155	726
Netherlands	132.0	19.7	14.4	12.3	9,191	1,603
Belgium	81.9	16.8	9.9	9.5	8,314	1,778
Denmark	56.4	10.2	5.1	4.8	11,020	2,141
Greece	34.8	6.0	9.8	8.6	3,534	700
Portugal	20.7	3.7	10.1	9.2	2,056	408
Ireland	18.0	2.7	3.5	2.9	5,118	935
Luxembourg	4.0	0.7	0.4	0.3	10,954	2,118
United States	*3,195.1*	*658.4*	*234.5*	*194.2*	*13,626*	*3,390*

Notes: a. In descending order of GDP size in 1983.
b. Figures may not exactly equal GDP divided by population because of rounding. In interpreting the value figures, allowance should be made for the fact that the exchange rates that have been used are but snapshots for 1983 and 1965.

Source: Computed from Organisation for Economic Co-operation and Development (1985): Tables 32, 34, 36 and 37.

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Summary of Rules Applicable to Transfer Pricing in France

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I. INTRODUCTION

Like all western countries, French law provides for the adjustment to arm's length of transnational transactions between related undertakings, with special emphasis on transactions with "*base companies*" located in tax haven jurisdictions (see Section 1 of Instruction of 4 May 1973).

The applicable provisions – in so far as they are not superseded by similar treaty provisions– are basically contained in two articles of the General Tax Code (CGI), an older one, *Article 57,* and a more recent one, *Article 238-A*, and implementing administrative Instructions (Instructions).

Article 57 lays down the rules generally applicable to transfer pricing.

Article 238-A is specifically directed against payments made to persons or entities located in tax havens and *Article 57,* as amended, extends to transactions with such persons or entities even if unrelated to the French undertaking involved.

The rules followed by the French Administration (Administration) in applying and carrying out the adjustment are – in addition to those expressed in its Instructions – those of the 1979 OECD Report on Transfer Pricing and Multinational Enterprises. In other words, the provisions of that Report are, in practice, also taken into account and combined with those of the Instructions by the Administration.

Reference should also be made incidentally to such concept of general scope as "*abnormal act of management*" evolved by the "Conseil d'Etat", the French highest administrative Court.

The French transfer pricing system is one in which adjustment is made, not on the basis of fixed norms like under Section 482 of the U.S. Tax Code, but through a determination of transfer pricing by reference to the circumstances of each specific case.

The purpose of this article is to offer a simple summary of the French rules applicable in respect of transfer pricing, and to highlight the most salient points of the network of means which are available to the Administration in order to straighten out transactions indirectly effecting a cross-border diversion of profits.

Formerly, only the most sizeable multinational groups were affected by anti-transfer-pricing measures, while the Administration now also keeps an eye on middle size undertakings conducting international transactions.

In this article, we will briefly analyze Articles 57 and 238-A CGI and review the basic transfer pricing implications of the main kinds of inter-companies transactions which may expose groups to tax adjustments.

The comments made are primarily by reference to the Administration's implementing Instructions related to Articles 57 and 238-A.

II. TRANSACTIONS BETWEEN RELATED UNDERTAKINGS: ARTICLE 57 CGI

2.1 Article 57 CGI

Article 57 CGI provides as follows:

> In assessing income tax due by undertakings which are controlled by or which control enterprises established outside France, the income which is indirectly transferred to the latter, either by increasing or decreasing purchase or sales prices, or by any other means, shall be restored to the trading results shown in the accounts. The same procedure is followed with respect to undertakings which are controlled by an enterprise or a group of enterprises also controlling undertakings located outside France.
>
> The condition of control or dependence is not required when the beneficiary of the transfer is established in a country or a territory with a privileged tax status as defined in Article 238-A, paragraph 2 of this Code (Article 90, paragraph II of the 1982 Finance Act).
>
> Should specific data not be available for making the adjustments provided in the foregoing paragraph, the taxable profits are determinable by way of comparison

with the profits of similar undertakings normally managed.

Article 57 CGI has been implemented through two Instructions from the Administration, namely Instructions 4-A-2-73 of 4 May 1973 and 4-A-5-83 of 15 April 1983.

2.2 Comments

2.2.1 For Article 57 to be applicable, the Administration must currently prove:

- That the French undertaking[1] is controlled by or controls a foreign undertaking or that both are controlled by a third undertaking or by a group or a consortium. If, however, the foreign undertaking is established in a tax haven as defined under Article 238-A (see below) the Administration does not have to prove control in order to avail itself of Article 57.
- That the transaction involved has not been concluded on an arm's length basis.

This latter proof entails a rebuttable presumption of transfer of profits abroad against the French undertaking.

2.2.2 Control of one undertaking by the other

The term "control" is not defined by Article 57. According to the French Administration and the "Conseil d'Etat", the relation of dependence between two companies may be legal or merely "de facto". The definition of a relationship entailing the applicability of Article 57 should be understood broadly and may be revealed by:

(i) *Legal control:*

A French undertaking is deemed to be controlled by a foreign undertaking where the latter holds a preponderant portion of the French company's shares of stock or where it holds the absolute majority of voting rights in shareholders' meetings or where, directly or indirectly, it exercises in the French company functions carrying decisive authority.

(ii) *"De facto" control:*

"De facto" control may be established by reference to any fact, including the existence of a contractual relationship.

There exists an ample set of decisions of the "Conseil d'Etat" related to the determination of "de facto" control, a number of which are quoted, by way of example, in the implementing Instruction of the Administration.

2.2.3 Transfer of profits abroad

Article 57 is aimed at preventing the cross-border transfer of profits achieved through an increase or a reduction of purchase or sales prices or through "other means". Such "other means" as quoted in he Administrator's Instruction, comprise, in particular:

- the payment of excessive royalties or assistance fees;
- low interest or interest free loans;
- waivers of claims, including in particular waivers of interest on loans;
- the granting of an advantage out of proportion with the services rendered as a consideration.

Article 57 stems from the broad concept of *abnormal management act* (acte anormal de gestion) which applies generally to all undertakings. The abnormal management act is defined by the "Conseil d'Etat", by reference to Article 39 CGI relating to the definition of business profits, as one which charges an expense or a loss to the account of an undertaking or which deprives the latter of due receipts, without that act being justified by the operation of the business (CE, 15 January 1965, No. 62009).

2.2.4 As above indicated, it is for the Administration to give evidence of the non-arm's length nature of the transaction, the transfer of profits then being presumed.

The French undertaking may always prove that the advantages granted to a foreign undertaking respond to real business requirements and do not stem from an intent to avoid French tax.

Article 57 specifies that the adjustment to arm's length is to be made by reference to the data specifically related to the case of the undertaking audited, and that it is only if such data are not available that a comparison with similar undertakings normally operated may be made (CE, 23 November 1960, req. No. 48570).

In its implementing Instruction, the Administration specifies that the adjustment by reference to the specific data of the undertaking audited is the common law method applicable to adjustment to arm's length of transactions carried out by French undertakings. It indicates further that the comparison with independent undertakings carrying on the same activities may be made on an arbitrary basis, for instance by applying the profits/turnover ratio of competitors (CE, 23 March 1953, req. No. 75326[2]).

Any amounts restored to profits in pursuance of Article 57 are treated like profits made available to shareholders otherwise than by the means of a distribution decided by the shareholders' meeting, thus excluding the benefit of the "avoir fiscal".

2.3 Application of Article 57 CGI to specific types of transactions

2.3.1 Sales

Transfer pricing by the means of inter-company sales

1. An undertaking may be an individual enterprise or partnership as well as a company.
2. It may be noted that this approach is somewhat different from that of the OECD Report (paragraph 11 and following) which refers primarily to the "comparable uncontrolled price" method, i.e. by direct reference to prices in comparable transactions between unrelated enterprises.

may be achieved either by increasing the prices or by decreasing the sales prices of the French undertaking.

In its Instruction of 4 May 1973, the Administration indicated that the arm's length price is, in general, the price at which the foreign manufacturer sells the kind of products involved to independent purchasers – such price obtainable, as the case may be, through French customs authorities – and that the entire set of transactions of the Group of companies involved, including the French subsidiary, should be considered.

In making its determination the Administration is currently confronted with two obstacles formed, on the one hand by the difficulty of identifying the products involved for the purpose of comparing them to similar products marketed by independent companies and, on the other hand, by the fact that the foreign undertaking escapes investigation except by the means of mutual administrative assistance and/or concurrent audits in pursuance of an applicable treaty or a special inter-Administrations arrangement.

However, the Administration admitted that a "strict" application of CGI, Article 57 might interfere with the establishment and operation of foreign sales branches or subsidiaries and jeopardize French exports. As a result, the following rules are applied by the French tax authorities:

- Where a French company exports goods through a foreign distributing branch or subsidiary, it must, in its financial records, make a distinction between manufacturing profits and sales profits. In principle, the sales profits are to be attributed to the foreign branch or subsidiary and, consequently, are not subject to French tax.
- Where the French company reduces its margin to meet competition on a foreign market, the tax authorities may decide not to apply Article 57 and, on the contrary, may even permit the French company to sell its products at a privileged price, even at cost. (See also Note of the Administration of 31 August 1959, BOCD 1959-II-893.)
- In the opposite case of sales to a French undertaking controlled by a foreign company, the prime reference is to the margin granted to the French distributing company.

2.3.2 Payment of excessive royalties or fees

Tax inspectors applying Article 57 have to determine if the royalties and technical or management assistance fees paid by the French undertaking are "legitimate" and if they actually correspond to "services actually supplied" by the foreign undertaking.

"Services actually supplied" should, with regard to royalties, be understood as meaning the supply of valuable patents, trademarks, know-how or other intangible rights normally compensated by the payment of royalties.

The rate of royalties or fees paid should be in accordance with the currently prevailing norms and their amount should not be so abnormally high as to reduce the amount of the net profits retained by the French undertaking, after such royalties and fees, below the level of profits normally made by French independent competitors. (See administrative Instruction of 4 May 1973 and CE, 3 August 1942, req. No. 65810.)

Royalties paid are also adjustable where they duplicate the compensation for group research expenses which are already payable to the licensor by the means of an increase of the price of goods or products which he supplies to the French undertaking.

The advantages granted by the French undertaking, e.g. by providing marketing or advertising services, to the licensor or performer, as the case may be, of technical or management assistance, should also be taken into account in appraising the position.

The fact that the rate of the inter-company royalties or payment thereof was approved by the Ministry of Industry, or other governmental authorities, in response to an application made in pursuance of legal requirements for submission, say, of license agreements, should not be disregarded by, but is not binding upon the tax inspector applying Article 57.

2.3.3 Loans and waivers of claims

2.3.3.1 *Loans*

Loans carrying no interest or low interest, made by a French undertaking, are adjustable in pursuance of Article 57.

In this connection like in others, the Administration adheres to the general principle established by the 1979 OECD Report on Transfer Pricing, under which:

> Once it has been established that an intra-group loan exists the general principle to be followed is that the loan should bear interest if interest would have been charged in similar circumstances in a transaction between unrelated parties (No. 192, p. 90).

If adjustment is made, an amount corresponding to the excess of normal interest rate on the interest rate actually applied is to be restored to the French undertaking's profits.

The normal interest rate to be retained as reference is the average interest rate applied by the Bank of France (see Instruction of 4 May 1973 and CE, 21 October 1970, req. No. 71071) or, as the case may be, the rate of the interest paid in respect of the amounts borrowed by the French undertaking itself. (CE, 7 November 1963, req. No. 57183.)

The French undertaking will escape adjustment if it proves that it obtained some advantages against the low-interest rate – or no-interest loan granted to the related foreign undertaking. This is so, for instance, when the foreign undertaking had itself guaranteed banking obtained by its French subsidiary (CE, 13 January 1967, req. No. 68139) or where the loss of interest incurred by the French lending undertaking is compensated by the benefit of increased sales profits obtained through the foreign undertaking (CE, 2 June 1982, req. No. 23342).

On the other hand, the fact that the foreign undertaking to which the French company made a no-interest loan to a subsidiary in difficulty is no proof by itself that the French company was acting in its own self-interest (RM Longuet 26 May 1980 – JO Deb. AN p. 2126).

2.3.3.2 *Waivers of claims*

The loss corresponding to a waiver of claim is deductible only if it constitutes a normal act of management.

The general status of waivers of claims under French tax law has been defined over the last few years by a number of major decisions of the "Conseil d'Etat".

The doctrine thus evolved by the "Conseil d'Etat" extends to waivers of claims by French undertakings on foreign related undertakings.

It is based on a distinction between waivers of claims made for *commercial reasons* – i.e. within the scope of a normal business relationship or in order to preserve the foreign subsidiary's position on the market (Instruction of 22 August 1983, No. 26) – or, otherwise, for *financial reasons*.

If made for commercial reasons, the corresponding loss is always deductible; if made for financial reasons, deduction of the loss by the French undertaking is allowed only up to the amount of the net loss of the foreign subsidiary.

Generally, the "Conseil d'Etat" rejects the deduction of losses corresponding to too frequent waivers of claims (CE 14 March 1984, req. No. 35030).

2.3.4 Apportionment of Group's overhead expenses

Such apportionment is related to similar services directly or indirectly rendered by one company of a Group – generally the parent – to the other.

It raises, as this is well known, some of the most difficult problems in respect of transfer pricing on account of the absence of any definite means permitting appraisal to what extent the services are actually rendered to the specific subsidiary and are accordingly deductible in the accounts of such subsidiary or, rather, benefits to the Group as a whole.

Another problem, to which the administrative Instruction of 4 May 1973 bears specific reference, is the contribution by a French company to the expenses of its foreign subsidiaries, including joint subsidiaries formed with another French company.

The apportionment on a lump-sum basis of costs incurred for the common benefit of French and foreign undertakings has been recognized in some instances (see CE 18 April 1966, req. No. 63621), but is, in any case, excluded in respect of transactions with companies located in tax havens.

According to the Administration the least questionable method which has also been approved by the "Conseil d'Etat" (CE, 25 April 1980, No. 45089) is to apportion costs among affiliated companies in proportion to turnovers.

Reference is also made in the Instruction of 4 May 1973 to a possible pro rated apportionment by reference to the respective assets of the companies involved.

III. PAYMENTS MADE TO INDIVIDUALS OR COMPANIES DOMICILED OR ESTABLISHED IN A TAX HAVEN COUNTRY: ART. 238-A CGI

3.1 Article 238-A CGI

Article 238-A CGI, provides as follows:

> Interest, arrears and other proceeds of bonds, claims, deposits and guarantees, royalties in consideration of the assignment or license of patents, trade-marks, process or manufacturing/formulas and other similar rights or the compensation for services, paid or owed by an individual or an entity domiciled or established in France to individuals or entities domiciled or established in a foreign State or in a territory situated outside France and there submitted to a privileged tax status, are not deductible in assessing tax unless the debtor proves that the disbursements involved correspond to real transactions and are not abnormal or exaggerated.
>
> In applying of the paragraph, an individual or company is deemed to be subject to a privileged tax status in a foreign country or territory if, under that status, he/it pays no tax or is liable to taxes on profits or income at a substantially lower rate than in France.
>
> The provisions of the first paragraph also extend to any payment made to an account with a financial institution established in one of the States or territories to which reference is made in that same paragraph.

3.2 Comments

3.2.1 Article 238-A establishes a rebuttable presumption that payments made to parties located in a tax haven country or territory are not made on an arm's length basis and are, accordingly, not deductible.

The Administration, in its Instruction of 26 June 1975 and a further administrative Note of 9 October 1975, has, for the purpose of Article 238-A but, on a general basis, defined the concept of tax haven through the notion of "privileged tax status" to which Article 238-A CGI bears reference.

The Administration has provided, as a practical rule, that a privileged tax status is deemed to exist if the taxes actually paid in the foreign country involved are one third less than the corresponding French taxes, or, if a tax on profits, is applied at a rate at least one third lower than the French corporation tax.

In the Note of 9 October 1975, the Administration has established a list of 41 countries considered as providing a privileged tax status, which list is said to be non-exhaustive. (It may be noted that, among those countries, Liechtenstein, Luxembourg, Jersey and Guernsey are the only ones situated in Western Europe.)

Article 238-A totally shifts the burden of proof on the taxpayer thereby reinforcing the means of action available to the Administration against abusive transfer pricing. This is why, in the Instruction of 26 June 1975, the Administration recommends that tax inspectors use Article 238-A rather than Article 57 CGI.

In order to rebut the presumption laid down by Article 238-A, the taxpayer has to prove that the payments challenged correspond to real transactions and are not unusual or exaggerated. He must even go as far as to prove the existence and performance of the transaction to which the payment relates, the mere production of documents – e.g. contracts – being deemed insufficient in this regard as any such documents are as well presumed to be fraudulent.

IV. CONCLUSIONS

This short review of the main rules applicable to transfer pricing under French law shows that the French approach to the problem, what is largely inspired by the 1979 OECD Report, is quite comparable to the approach of most of the other developed countries with special emphasis on transactions with "base companies" located in recognized tax havens.

Concurrently, with a continued reinforcement of the means to combat tax evasion and tax avoidance, there exists in France at this time a trend to give increased guarantees to taxpayers for a proper and reasonable application of the law, regarding in particular the burden of proof and the production of evidence.

In this respect a report has recently been made by an "ad hoc" committee (Commission "Aicardi") to the French Government in respect of the relations between the Administration and the taxpayer. This report contains no statement regarding transfer pricing, except for a reference to the determination in each specific instance of the existence of a "privileged tax status" as defined in Article 238-A CGI, which is worth mentioning.

Conference Diary

JANUARY 1987

British Branch of I.F.A.: Tax Aspects of Financial Instruments. London, 8 January (English).

The American Tax Institute: Basic elements of U.S. Federal taxation (incorporating the U.S. Tax Reform Act of 1986). Lésigny, 12-17 January (English).

European Study Conferences Limited: 8th Annual ESC Conference on International Transfer Pricing for Multinationals. London, 14 January (English).

European Study Conferences Limited: Introduction to Trust Planning. London, 15 January (English).

European Study Conferences Limited: Advanced Strategy for Inheritance Tax. London, 20 January (English).

European Study Conferences Limited: VAT – the Right to Deduct Input Tax (Customs' new Proposals). London, 28 January (English).

FEBRUARY 1987

British Branch of I.F.A.: Australian Tax Developments. London, 4 February (English).

Legal Studies & Services Limited: VAT planning for land transactions; VAT planning for partially exempt businesses (two optional half day seminars). London, 4 February (English).

Legal Studies & Services Limited: Shares & Trusts for executives & employees. London, 11 February (English).

British Branch of I.F.A.: Exchange of Information; Transfer Pricing; Treaty Abuse. London, 24 February (English).

European Study Conferences Limited: Hedging Currency Risk – Techniques and Taxation. London, 24 February (English).

European Study Conferences Limited: Exporting a trust. London, 25 February (English).

MARCH 1987

Münchner Steuerfachtagung e.V.; Finanzpolitik und Steuerrecht; Grundfragen des neuen Bilanzrechts; Die Umsatzsteuer in der Praxis; Steuerberatung und Prüfung bei mittelständischen Unternehmungen; Internationales Steuerrecht- Luxemburg. München, 25-26 March (German).

McGeorge School of Law: Business transactions and investment in Asia and the Pacific. Waidring, 29 March - 4 April (English).

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POLAND:

The Trends in Taxation of Foreign Enterprises (1945-1986)

By Professor Dr. Apoloniusz Kostecki

1. The term "foreign enterprises" may cause some misunderstanding. In this article, it will be used – with some reservation – to define the term introduced in the Law of 2 July 1982.[1] The term "foreign enterprise" refers to legal entities domiciled abroad, owned by Polish and non-Polish citizens domiciled abroad, as well as partnerships established by those entities that carry out any economic activity within the territory of the Polish People's Republic. The above-mentioned reservation results, to some extent, from the retrospective character of this article where the concept of "foreign enterprise" does not always comply with the legal definition limiting its economic activity to enterprises in industry services, trade, export of the enterprises' products and services, as well as the importation of goods to provide for the needs of the enterprise. Nevertheless, the economic activity carried out by these enterprises is of primary importance to this article. This article will present trends in taxation of income derived by foreign enterprises of non-socialist countries. Such taxation will be discussed in relation to a number of economic, social and political issues. These issues have been taken into consideration to formulate the respective regulations which define the legal status of foreign enterprises and determine the economic activities which may be carried out in the territory of a socialist country. The enterprises are expected to stimulate production and increase services offered to the domestic market as well as introduce modern technology and business organizations into the national economy.

Two distinct periods can be seen in the development of the principles of taxation concerning foreign individuals and legal entities in the Polish People's Republic.

In the first period (1946-1972) the uniform principles of taxation were applied to all foreign enterprises irrespective of their activity or their legal status. In the second period (1973-1986) taxation was divided in its emphasis: first, according to the kind of economic activity (1973-1975) and second, according to the legal status. An explanation of the principles of taxation which existed in interwar Poland (1918-1939) will precede the presentation of these two periods. This is for two reasons:

1. to accentuate the contrast, and
2. to point out that basic provisions of the interwar Poland tax system, which had been binding until early September 1939, were effective in the Polish People's Republic until the end of 1945. Moreover, that system was the starting point for the creation of the tax system of the Polish People's Republic.

2. The tax system of interwar Poland taxed all enterprises equally, irrespective of their place of permanent residence or where their capital was invested. Consequently, no particular tax preferences were granted in the case of foreign capital investments nor was the taxation discriminatory against any foreign legal enterprises. This is to be stressed particularly in view of the significant role played by foreign capital in the economic system of interwar Poland. In 1933, foreigners controlled 68% of the capital of all companies active in Poland at that time.[2] However, the direct economic activity performed by foreign enterprises was considerably smaller and showed a tendency to decline. In 1930 foreign joint-stock companies owned 13.6% of all capital, invested in Poland, but by 1936 it was barely 6.7%.[3]

The principle of equal taxation of domestic and foreign enterprises is represented by the income tax applied in interwar Poland and effective until the end of 1945.[4] That tax will also serve as an example for later regulations. A characteristic feature was that it related not only to individuals, but also to legal entities. However, this was a disputed theory.[5] Foreign individuals were liable to taxation only on their income derived in the Polish territory from the sources of income as prescribed by the law such as ownership of real estate, the management of industrial and trade enterprises and employment. This was on condition that they stayed in the territory of Poland for a period not exceeding

1. The Law of 6 July 1982 on articles concerning the performance of activities by foreign individuals and legal entities in the field of small-scale production in the territory of the Polish People's Republic (Dziennik Ustaw No. 19 item 146, amendments: Dziennik Ustaw 1983 No. 42 item 187, Dziennik Ustaw 1985 No. 2 item 12, uniform text: Dziennik Ustaw 1985 No. 13 item 58).
2. Compare Z. Landau, J. Tomaszewski, Economy of Interwar Poland 1918-1939, Vol. III. The Big Crisis (1930-1935), 1982, page 96 and K. Ostrowski, Financial Policy in Prewar Poland, 1958, pages 37-43.
3. Z. Landau, J. Tomaszewski, Foreign Capital in Poland 1918-1939, Materials and Documents, 1964, page 15.
4. The Law of 16 July 1920 on State income tax, according to the last uniform text of 1935 (Dziennik Ustaw 1936 No. 2 item 6, amendments: Dziennik Ustaw 1938 No. 26 item 226, Dziennik Ustaw 1939 No. 89 item 566, Dziennik Ustaw 1944 No. 9 item 46 and Dziennik Ustaw 1944 No. 15 item 87).
5. Compare J. Zdzitowiecki, The Concept of Income in the Polish Income Tax, 1939, pages 21-22.

one year. If they remained longer than one year, they were liable to taxation on their entire income including that derived outside the territory of Poland. Foreign legal entities acted under the same principles. The location of their management would determine their tax liability, in accordance with the stipulations of Article 1(5) of the Income Tax Law. Thus, those legal entities whose management was located within Poland were liable to tax on their world-wide income, i.e. income derived from all the sources whether in Poland or abroad. Whereas legal entities which had their management located abroad (i.e. foreign legal entities) were liable to taxation only on income derived in the territory of Poland and only from sources such as industrial and trade enterprises, as well as ownership of real estate or claims secured on real estate.

There was one exception to the principle of equal taxation of foreign and Polish legal entities: i.e. foreign entities were subject to special stamp duties on the transfer of their capital to Poland in the form of share capital and on other capital, e.g. bond loans. Another circumstance of equal taxation of both foreign and domestic companies is the double taxation of profits, i.e. first, on the income derived by the enterprise and second on income derived by its partners or the shareholders. The effects of such double taxation were mitigated by application of a lower income tax rate for legal entities than for individuals. The result was that legal entities were liable for tax amounting to a maximum 35% of income, while the tax burden levied on individuals amounted to 50% of their income.[6]

However, the principle of equal taxation as discussed above only appeared to create an advantageous situation for foreign enterprises. In fact, their incomes were liable to "international" double taxation because of the relatively small number of countries which had signed a tax treaty with Poland. This was the reason why only a few foreign enterprises were prepared to carry out direct economic activity in interwar Poland.[7] In the period between 1918-1939 Poland signed only five international tax treaties. These were: Czechoslovakia in 1925[8]; Hungary in 1928[9]; the Free City of Gdansk in 1929[10]; Austria in 1932[11]; and Germany in 1923[12] (cancelled, however, in 1934).

The principles for the avoidance of double taxation were sometimes the subject to trade treaties concluded by Poland. This occurred with France, Denmark, Finland and the Netherlands.

These tax treaties eliminated double taxation to a great extent. Income derived from industrial and trade enterprises was subject to tax in the country of residence. When such activity was carried out in territories of both contracting countries, the tax was levied on income sourced to the taxing country. Dividends paid by companies were taxable in the country of residence of the recipient. Income derived from real estate or other property was subject to tax only in the country where such real estate or other property was located.

3. The tax system for foreign enterprises of interwar Poland served as a general guide for regulations introduced later by the Polish People's Republic. The change in the political system after the Second World War influenced the structure of income taxes to favor the socialized sector of the economy. Foreign enterprises were of little importance in Poland at that time since the majority of businesses had been nationalized. The two norm-setting acts (i.e. the Decree Law of 8 January 1946[13] and the Decree Law of 25 October 1948[14] on income tax) regulated taxation of income in the socialized and non-socialized sectors of the economy decidedly in favor of the former one. This created an inconvenient situation for foreign enterprises since those regulations were aimed against economic activities of a private, capitalistic character. Some of the basic distinctions with the former regulations should be mentioned.

The new income tax structure, as well as the later ones, introduced different principles of taxation which varied according to the character of the enterprises and, in respect of non-socialized enterprises (discriminated against in certain periods of time), also according to the sources of the income. Discrimination was observed in the Income Tax Law of 1946 when the maximum tax rate of 65% was fixed for the non-socialized sector. For private, capitalistic enterprises the rate increased to 80%. The same norm-setting act stipulated that the tax levied on cooperatives must not exceed 1/3 of their balance sheet profit while the tax applied to state enterprises was a maximum 10% of profit. The different treatment of the various forms of enterprises (i.e. private, cooperative or state) was introduced in the schedules of the Income Tax Law of 1948, together with a two-stage income tax burden. Taxation of income of particular entities was the first stage, and taxation of total income the second. In accordance with the theory that income tax functions as an instrument against private, capitalistic property, these enterprises were subject to the heaviest tax burden. A similar income tax structure can be found in the Decree Law of 26 October 1950.[15] There the tax regulations were supposed to play an important role in the "anti-capitalist battle".[16] From that time forward, the socialized sector was regulated by separate norm setting acts. It should be mentioned that the Law of 16 October 1972,[17] on income tax, discontinued

6. In some regions of Poland a communal supplement amounting to 5% of the income derived might have been applied.
7. M. Waluga, Taxation of Foreign Units of Economy in Poland 1918-1939, Finance 1984 No. 10.
8. Agreement on Avoidance of Double Taxation in the Field of Direct State Taxes of 23 April 1925 (Dziennik Ustaw 1926 No. 14 item 83).
9. Convention for the Avoidance of Double Taxation in the Field of Direct State Taxes of 22 May 1928 (Dziennik Ustaw 1931 No. 75 item 604).
10. Dziennik Ustaw 1934 No. 49 item 472.
11. Agreement on Avoidance of Double Taxation in the Field of Direct Taxes and on Legal Assistance in respect of Tributes of 22 April 1932 (Dziennik Ustaw 1933 No. 91 item 704).
12. Not published.
13. Dziennik Ustaw No. 2 item 14.
14. Dziennik Ustaw No. 53 item 414.
15. Dziennik Ustaw No. 49 item 450.
16. Compare S. Kolakowski, Taxation of Non-socialized Economy (Agriculture Excluded), Finances in the Polish People's Republic in 1944-1960, 1964, page 374.
17. Dziennik Ustaw No. 53 item 339.

two-stage taxation but maintained the schedular character of the income tax. This resulted in the tax tables being subject to continuous amendments.[18] The highest tax rate ever applied was 85% of income which was obligatory for many years.

All successive income tax systems, beginning with the Income Tax Law of 1972, treat foreign enterprises no less severely than domestic enterprises engaged in economic activities of a private, capitalistic nature. Moreover, the atmosphere was utterly unfavorable for such enterprises with a few exceptions such as the time following the social-political changes of October 1956.

With respect to the taxation of income earned by foreign enterprises, the principle of equality was maintained within acceptable limits. The principle of a limited tax duty on income earned in the territory of the Polish People's Republic from specified sources has been gradually increased and, apart from the sources included in the limited tax duty in interwar Poland, in 1946 it applied to income from patents, inventions and production methods, royalties and license fees. In 1948 income from the sale of property and property rights and the sale of interest in an enterprise, except for shares, were included. Income from reinsurance by Polish insurance companies was added in 1950. And in 1972, all kinds of income derived by foreign enterprises in the territory of Poland were included in the limited tax duty.

The income tax regulations of 1946 contain an element of discrimination against foreign enterprises because they only allowed *domestic* entities to exempt income from partnership's rights and dividends from tax. By 1948 the non-socialized domestic enterprises were deprived of this privilege. Also noted is that, in relation to foreign individuals staying in Poland the period of exemption from a world-wide tax liability was limited to 6 months. This has become a permanent feature of the Polish tax system. Generally, the need to treat foreign enterprises differently than domestic enterprises carrying on economic activity of a private, capitalistic nature had not been perceived during the period between 1946 and 1972. This may have been because there was no opportunity for the expansion of economic activity in the territory of Poland during this period.

4. The change in the tax policy in relation to foreign enterprises was gradually revealed in the early 70's as the need to introduce new technology increased.

As a result of this change, the Minister of Finance, acting under the authority of Article 20(2) of the Income Tax Law of 1972, granted foreign enterprises a number of preferences by the end of 1973.[19] In particular, he had exempted from tax income derived from trade when all business transactions were conducted through Polish trade enterprises. Further based upon the reciprocity principle, income derived by sea and air navigation enterprises was exempted from taxation. The highest level of income tax burden applicable to foreign enterprises was fixed at 50%. A preferential rate of 30% was granted in respect of income derived from patent royalties, license fees, trademark and copyright royalties, as well as from the leasing of films, interest from loans, dividends and other income distributed by legal entities. In this manner double taxation of profits was mitigated. Moreover, the possibility of further tax reductions for individual partners was anticipated. A lump sum tax consisting of income plus turnover tax made a particular form of preference applicable. This existed in the case of income derived by foreign air navigation enterprises not exempted from tax (10%) or income derived from entertainment and sport activities organized by Polish enterprises (12%).

The year 1976 was a turning point in the treatment of foreign enterprises, with the introduction of new principles in taxation. The taxation of foreign enterprises started to be differentiated not merely by the kind of business in which they were engaged, but also according to their legal status.

It was characteristic of this time that the legal status of foreign enterprises be defined by the indirect method or regulation. This meant that minor acts of law granted permission to engage in a specific business within Poland. In this way the legal status was defined with regard to:

(a) agencies of foreign enterprises[20]
(b) the companies directly active in the field of handicrafts, domestic trade, catering and hotel services as well as other production and service activities,[21] and
(c) joint ventures.[22]

At this time joint ventures began to appear. Foreign enterprises, as well as associations and organizations of the Polish emigrants carrying on activities outside of Poland could now become partners with certain domestic enterprises. These domestic enterprises were either State-owned or social organizations which had been granted permission to become partners in a joint venture.

The wide variety of activities carried out by foreign enterprises as well as their new legal status was reflected in the newly developing principles of taxation.

18. Structure of that tax table was amended by virtue of the Law of 18 December 1976 (Dziennik Ustaw No. 40 item 231), see 31 Bulletin p. 559 (1977).

19. The Ruling of the Minister of Finance of 2 November 1973 on taxation of individuals living or being domiciled abroad who derive income in the territory of the Polish People's Republic (Dziennik Ustaw No. 46 item 274).

20. The Ruling of the Minister of Finance of 6 February 1976 on conditions, mode and the State agencies authorized to grant foreign individuals and legal entities rights for establishing agencies conducting business in the Territory of the Polish People's Republic (Dziennik Ustaw No. 11 item 63, amendment: Dziennik Ustaw 1984 No. 26 item 133).

21. The Ruling of the Minister of Finance of 14 May 1976 on granting foreign individuals and legal entities permissions for conducting certain kinds of business (Dziennik Ustaw No. 19 item 123, amendment: Dziennik Ustaw 1978 No. 31 item 135).

22. The Instruction of the Ministry of Finance of 26 May 1976 on permissions granted to partnerships of mixed capital to carry out certain turnover activity in the field of foreign currency (Monitor Polski No. 25 item 110).

As a result of the amendment of the Income Tax Law of 1972[23] foreign enterprises were taxed at a rate of 50% on income derived in Poland. This constituted a remarkable preference when compared with the progressive taxation applied to domestic enterprises which had a maximum rate of 65%. Moreover, by virtue of the Ruling by the Minister of Finance on 23 May 1977,[24] the number of special preferences was increased by the addition of an exemption from tax on income derived from handicrafts, catering and other services, and trade by foreign enterprises for a period of two years, with regard to hotel services, the period was 3 years. In 1985,[25] the 3-year exemption period was extended to include all other activities. If the tax exemption is not utilized, the income tax assessment is based on the lowest tax schedule. The handicrafts enjoyed particular preference with respect to the income derived from export activity, i.e. 5% of the turnover was deducted from the total amount of income tax and turnover tax. However, the total tax was not to be lower than 1% of the export turnover value. Also, based on the reciprocity principle, an exemption was introduced for foreign enterprises which derived interest on loans granted to domestic enterprises.

Income earned by foreign agencies was subject to taxation in accordance with the principles commonly in use. This is in contrast to the above-discussed categories of entities which were granted special preferences. On the other hand, joint ventures with Polish capital amounting to over 50% of the capital stock in total have been recognized as domestic enterprises and, consequently, their income was subject to tax at a rate of 65%, as determined by special regulations.[26]

Limited liability joint ventures came into existence by virtue of a decision by the Council of Ministers on 7 February 1979.[27] As stated above, only State-owned enterprises (i.e. State and cooperative enterprises) have been allowed to participate in such joint ventures. The State-owned share must be at least 51% of the capital stock. Foreign individuals and legal entities have been accepted as partners. The businesses were supposed to be manufacturing goods for the domestic market and for export. Modern technology and modern production systems were to be employed. These companies have been subject to tax provisions applicable to State enterprises and have paid income tax as stated above.[28] The possibility of exemption from income tax for a period of 3 years from the date of establishing the enterprise has also been provided on the condition that at least one-third of income is re-invested.

The modification of the legal status of foreign enterprises engaged in small-scale production, as provided by Law in 1982,[29] brought about further changes in the tax code. Through the passage of new laws, foreign enterprises have been granted a solid legal basis for their businesses. For example, businesses have been granted licenses to act for a period of twenty years and, in cases justified by a need to amortize the investment, even up to 40 years. These licenses may be cancelled only in the case of a breach of the law or a breach of the license's stipulations. Provisions in the Law govern the activities of the foreign enterprise when registered as either "foreign enterprise" or "enterprise with foreign capital participation", the latter having all the characteristics of a joint venture. Polish enterprises eligible to participate are: State enterprises of small production; cooperatives; social organizations or domestic private enterprises; individuals; domestic partnerships; and producers' associations. The important point is that the foreign as well as the Polish enterprises are free to choose an appropriate legal form for the enterprise. The only limitation refers to the nature of their activity. That is, they are to work in small-scale production, i.e. manufacturing goods, rendering services, selling and exporting their own products and services and, lastly, importing goods to fulfill needs of their own production.

Foreign enterprises which represent the "foreign enterprise" type are subject to taxation according to the provisions commonly applied to the non-socialized sector. The provisions concerning the taxation of "foreign enterprises" were inserted into the Law of 1982 as stated above, however, this is in conjunction with the proper authorization by the Minister of Finance.[30]

These actions were a reflection of a tendency to act independently in a misguided attempt to provide foreign companies with sufficient guarantees. However, the legal rules comprising those provisions were abolished soon and their contents have been incorporated into the Income Tax Law of 1972 commonly in use under the terms of uniform wording of 1983.[31]

Pursuant to these provisions, the tax applicable to such companies is to be assessed upon their income exceeding 160,000 zloties according to the basic tax table of progressive tax rates, which range from 20% up to 85%,[32] with respective tax reductions applied. This is an evident privilege granted to foreign enterprises. However, certain important limitations as provided by the Law must not be ignored, i.e. the minimum income tax rate may not be lower than 50%

23. Dziennik Ustaw 1976 No. 40 item 231.
24. The Ruling of the Minister of Finance of 23 May 1977 on taxation of foreign individuals and legal entities (Dziennik Ustaw No. 18 item 71, amendments: Dziennik Ustaw 1979 No. 8 item 49 and Dziennik Ustaw 1981 No. 28 item 148).
25. Dziennik Ustaw 1981 No. 28 item 148.
26. The decision of the Council of Ministers of 24 January 1973 on income tax on certain companies in a socialized economy (Monitor Polski No. 4 item 27).
27. Decision of the Council of Ministers of 7 February 1979 on establishing and conducting businesses with participation of foreign capital in the Polish People's Republic (Monitor Polski No. 4 item 36).
28. Circular of the Minister of Finance of 30 August 1979 on the enterprises with participation of foreign capital and on settlement of their accounts with the budget (Dziennik Urzedowy of the Ministry of Finance No. 11 item 25).
29. See annotations No. 1.
30. The Ruling of the Minister of Finance of 15 November 1982 on income tax levied on certain foreign units of economy (Dziennik Ustaw No. 36 item 237).
31. Dziennik Ustaw No. 43 item 192.
32. Since 1985 the range of rate has been limited at 10% – 80% of income Dziennik Ustaw No. 12 item 51).

of the income derived. The Disposition of 29 July 1983[33] provides for a reduction of the taxable base as follows: 20% on the income derived from sale of goods which reduce importation; and 10% on income derived from goods or services supplied to farmers assisting them in their work, which enhance food production as well as from manufacturing medical equipment and means for plant preservation.

A preference of a special kind is represented by the total tax exemption granted to foreign enterprises for a period of 3 years from the date of starting their activity provided, however, that at least 1/3 of their income will be spent on building or assembling in relation to their business. In other cases, such allowance will be granted as per the code, i.e. up to the 50% of the sums spent on building and assembling, as a reduction from the income tax due.[34]

The joint ventures, as defined by the Law of 1982, are subject to taxation, as stated above, if they have obtained the status of a legal entity. Otherwise, they are subject to taxation at a rate of 50% of their income, the same as foreign enterprises which are not covered by the Law of 1982.

The Law of 23 February 1986[35] on joint ventures (limited liability or joint-stock companies) is proof of a desire to have the legal status of foreign enterprises active in Poland regulated by law. The number of the foreign enterprises is not limited. However, their partner's share is limited in accordance with the principle that the Polish partner's share should amount to over 50% of the total capital stock. Joint ventures of this type are being recognized as legal companies in the socialized economy. This accounts for the fact that provisions pertaining to their economic activity have been determined in comparatively detailed manner. These companies are not limited to the field of small-scale production alone.

These joint ventures are taxed according to the same provisions applied to State-owned companies.[36] However, the Law of 1986 has settled some deviations from these principles. In particular, the tax rate is set at 50%, whereas the commonly binding tax rate was 65%. Moreover, the tax rate may be further decreased, namely by 0.40% for each percentage point of total sales earned by export. The essential point is that these companies are exempt from income tax for a period of 2 years from the date of starting their activity. The parts of profit spent on building or assembling is still exempt after a lapse of this period.

5. Recapitulation of the principles of taxation of income derived by foreign enterprises in Poland as accomplished above results in a question about the purpose of differentiating the provisions concerning taxation of companies in accordance with their "citizenship". This is because the effect of such an operation has always been, more or less, tax discrimination against certain categories of companies. The arguments based upon the theory that the tax allowances granted to foreign enterprises are intended to neutralize the effects of double taxation, as had been claimed in the period of interwar Poland. In fact, this argument is greatly weakened in light of the significant number of tax treaties signed with countries of different political systems within the period of 1970-1985. The agreements are similar to the OECD Draft Convention for the Avoidance of Double Taxation with respect to taxes on income and capital. From this it appears that the best method is to support uniform conditions for all enterprises irrespective of their "citizenship". This is the reason why the attempt to tax foreign enterprises under the same law as for domestic enterprises should be highly appreciated. The attempt to treat equally all enterprises irrespective of their economic sector, should also be noted. This has already become a rule of law in relation to Polish agriculture.

33. The Ruling of the Council of Ministers of 29 July 1983 on reduction of income tax levied on the income derived by enterprises with participations of foreign capital which have obtained status of legal entity and on the income derived by foreign enterprises, as well as on tax allowances granted on the grounds of investments (Dziennik Ustaw No. 43 item 194 amendments: Dziennik Ustaw No. 60 item 307).
34. Compare the Law of 19 December 1975 on tax allowances granted, due to the investment process (Dziennik Ustaw No. 45 item 230), as well as the Ruling of the Council of Ministers of 17 December 1984 on tax allowances granted due to the investment process (Dziennik Ustaw No. 60 item 307).
35. The Law of 23 April 1986 on companies with participation of foreign capital (Dziennik Ustaw No. 17 item 88).
36. The Law of 26 February 1982 on taxation of a socialized economy (Dziennik Ustaw No. 7 item 55, uniform text: Dziennik Ustaw 1986 No. 8 item 45).

REPUBLIC OF SOUTH AFRICA:

The Income Tax Law since the Second World War

By Dr. Erwin Spiro LL.D. (h.c.)

INCOME TAX – A CREATION OF STATUTORY LAW

Like any tax or similar levy, etc., the income tax in South Africa is based on statutory law. The first Income Tax Act of the Union of South Africa – which became a Republic in 1961 – was passed by Parliament in 1914 (Act No. 28 of 1914). That Act was based on the Income Tax Assessment Act of New South Wales of 1895 (59 Victoria, 15). In this context "income" meant "gains or profits". The 1914 Act was replaced by the Income Tax (Consolidation) Act of 1917 (Act No. 41 of 1917). "Income" was no longer defined as meaning "gains or profits". The Act also introduced a super tax and a dividend tax. The rate of tax was now to be fixed annually by Parliament, but the amending annual Acts were not confined to the incidence of the rate alone. The 1917 Act was replaced by the Income Tax Acts of 1925 (Act No. 40 of 1925) and of 1941 (Act No. 31 of 1941), respectively. The 1941 Act was replaced by the Income Tax Act of 1962 (Act No. 58 of 1962). All taxpayers in South Africa are taxed on the basis of the (principal) Income Tax No. 58 of 1962, as amended. Therefore, any description of the development of the South African income tax law for the last forty years must begin with the 1941 Act.

A BRIEF OUTLINE OF THE INCOME TAX LAW FORTY YEARS AGO

The income tax, still referred to as the normal tax, is not based on taxable income, but on "receipts or accruals"[1] which yield a "taxable amount" after a number of eliminations. This position may be summarized as follows: the total amount whether in cash or otherwise, received by or accrued to or in favor of any person, excluding receipts or accruals of a capital nature, in any year or period assessable from any source within or deemed to be within the Union, including such items as income received or accrued as a result of services rendered or to be rendered, constitutes gross income. The deduction from gross income of any amounts exempt from normal tax will yield income. The amount remaining after the deduction from the income by any person of all the amounts – other than abatements – allowed to be deducted is taxable income. Finally, taxable amount is the amount remaining after deducting from any taxable income any abatement allowed.

The Act deals specifically with certain activities, such as insurance, mining, shipping and farming. Both natural persons and companies, as defined in the Act, are subject to the normal tax. However, there are some differences. Furthermore, the rate of normal tax is progressive in the case of a natural person, although it does become fixed when a certain amount is exceeded, whereas the rate is fixed throughout in the case of a public company. Objections may be raised concerning assessments. If the objections are rejected an appeal may be made to a specially constituted court.

This court's judgement may also be appealed, but only on a question of law, to the provincial division of the Supreme Court or, in certain instances, directly to the Appellate Division. A special section of the Act deals with tax avoidance. There is also a provision for a non-resident shareholders' tax on dividends declared by public companies, and an undistributed profits tax covering public companies. The Act also creates a system which apportions the taxable income and income subject to super tax of private companies among the shareholders according to the right of each to participate in the income and profits of the company. Husband and wife are subject to normal income tax on the total of their respective taxable incomes, married persons paying less tax than married ones in respect of the same amounts. There is also a provincial income tax.

Shift towards indirect taxation

An income tax is generally held to be a direct tax. In 1968, however, the Franszen Commission of Enquiry into Fiscal and Monetary Policy in South Africa[2] recommended a shift of emphasis in the direction of indirect taxation through the introduction of a sales tax. Dr. Diederichs, then Minister of Finance, endorsed this view in his 1969 Budget speech, pointing out that it reflected a general development.[3] Canada, as well as Norway and New Zealand although still preferring an income tax as based on the taxpayer's

1. See Spiro *The Receipt or Accrual Basis of the South African Income Tax* in (1973) 6 CILSA 199-224.
2. First Report November 1968, RP 24/1969 §§26, 148 and 152.
3. See also Leif Mutén *On the Development of Income Taxation since World War I*, International Bureau of Fiscal Documentation, Amsterdam 1967, 76 and Prof. Dr. Schomölders, *Turnover Taxes*, International Bureau of Fiscal Documentation, Amsterdam 1966, 9.

ability to pay, recognized the importance of a sales tax. Likewise the British Chancellor of the Exchequer, Mr. Jenkins, mentioned in his 1968 Budget speech various reasons for indirect taxation being the most appropriate source for Government revenue. He added that indirect taxation, to some extent, left the public the choice to spend or save. In South Africa, however, the Sales Tax No. 103 of 1978 did not take effect until 28 June 1978. The sales tax has already been instrumental in allowing the Government to grant a number of important income tax concessions. The Margo Report will probably endorse this policy.

Standing commission of inquiry into taxation policy

There is a standing commission of inquiry into taxation policy to advise the Minister of Finance whenever required.

Margo Commission

The present socio-economic circumstances in South Africa have made the appointment of yet another commission of inquiry into the tax structure of the Republic of South Africa necessary to secure a tax system capable of contributing significantly to the long-term socio-economic development of the South African community. The Commission, chaired by Mr. Justice Margo, has a wide-ranging mandate. After having worked diligently over the past fifteen months it is now reaching a conclusion. In this March 1986 Budget speech Mr. Barend du Plessis, the Minister of Finance, expressed his expectation that the final report would be submitted later in the year. The Minister said he would await the Margo Commission's report before introducing far-reaching changes in the tax structure.

SOME FAMOUS GUIDELINES PRONOUNCED BY THE APPELLATE DIVISION

Capital v. revenue

One of the most crucial problems in the South African income tax law is the capital or revenue nature of a receipt, accrual or expense. An accrual or receipt of a capital nature is ordinarily not subject to the tax whereas an expense of a capital nature ordinarily does not qualify as a deduction. There is no statutory definition.

Holmes, JA, in *Natal Estates Ltd. v. Secretary for Inland Revenue,*[4] a unanimous decision, stated:

> In deciding whether a case is one of realizing a capital asset or of carrying on a business or embarking upon a scheme of selling land for profit, one must think one's way through all of the particular facts of each case. Important considerations include, inter alia, the intention of the owner, both at the time of buying the land and when selling it (for his intention may have changed in the interim); the objects of the owner, if a company, the activities of the owner in relation to his land up to the time of deciding to sell it in whole or part; the light which such activities throw on the owner's *ipse dixit*[5] as to intention; where the owner sub-divides the land, the planning, extent, duration, nature, degree, organization and marketing operations of the enterprise; and the relationship of all this to the ordinary commercial concept of carrying on a business or embarking on a scheme for profit. Those considerations are not individually decisive and the list is not exhaustive. From the totality of the facts one enquires whether it can be said that the owner had crossed the Rubicon and gone over to the business, or embarked on a scheme, of selling such land for profit, *using the land as his stock-in-trade*.

As may here be mentioned, according to a Cape Town newspaper dated 11 June 1986, the Johannesburg Stock Exchange asked the Margo Commission to define income and capital gain, pointing out that, in the United States of America, an asset held for more than six months is of a capital nature.

If an expense is incurred to acquire a capital asset for a business, it is a non-deductible capital expenditure even if it is paid in annual installments. If, however, the expense is part of the cost incidental to the performance of the income-producing operation (as distinguished from the equipment of the income-earning structure), then it is a deductible expenditure. This is true even if paid in a lump sum,[6] provided the expenditure is sufficiently closely connected with,[7] or covers necessary concomitants of,[8] those income-producing operations.

Source

The basis of liability for income tax in South Africa is not residence, but the source of the receipt or accrual. The rationale is that a country which produces wealth by virtue of its natural resources or the activities of its inhabitants is entitled to a share of that wealth wherever the recipient of it may live. Double taxation agreements avoid hardships.

However, there is again no statutory definition of

4. 1975(4) SA 177 (A), at 202G-203 in principle.
5. The ipse dixit of the taxpayer and his credibility have to be considered with great care, however much he is in an unenviable position of having the onus to prove that the decision of the Commissioner for Inland Revenue is wrong, *Malan v. Kommissaris van Binnelandse Inkomste* 1983(3) SA 1 (A) (unanimous), at 18-19, per Rabie CJ.
6. *New State Areas Limited v. Commissioner for Inland Revenue* 1946 AD 610, at 627, per Watermeyer CJ; *Secretary for Inland Revenue v. Cadac Engineering Works (Pty) Ltd.* 1965(2) SA 511 (A), at 522 per Ogilvie Thompson JA, as he then was; *Palabora Mining Co. v. Secretary for Inland Revenue* 1973 (3) SA 819 (A) (unanimous), at 833F, per Ogilvie Thompson CJ.
7. *Port Elizabeth Electric Tramway Co. v. Commissioner for Inland Revenue* 1946 CPD 241, at 245 per Watermeyer AJP, as he then was. See also the unanimous decisions in *Commissioner for Inland Revenue v. Nemojim* 1983(4) SA 935 (A), at 947G, H, per Corbett JA and *Commissioner for Inland Revenue v. Standard Bank of South Africa* 1985(4) SA 485 (A), at 498 G, per Corbett JA (important, sometimes overriding, factors are the purpose of the expenditure and what the expenditure actually effects).
8. *Joffre & Co. Ltd. v. Commissioner for Inland Revenue* 1946 AD 157, at 163, per Watermeyer CJ and see *Stone v. Secretary for Inland Revenue* 1974(3) SA 584 (A) (unanimous), at 594, per Corbett AJA, as he then was.

source. The leading case is still *Commissioner for Inland Revenue v. Lever Bros. and Another.*[9] In the words of Chief Justice Watermeyer, source is not the quarter whence the receipts or accruals come, but their originating cause. That originating cause is the work the taxpayer has done in order to earn the receipts or accruals; it may take the form of personal exertion, mental or physical or it may take the form of employment of capital either by using it to earn income or by lending its use to someone else.[10] Once the originating cause has been ascertained, it must be located, and if it occurred in the Republic of South Africa, the receipts or accruals may be subject to income tax.

Tax avoidance

In *Commissioner for Inland Revenue v. Louw,*[11] it was held that the incorporation of the practice of consulting engineers and the rights and obligations created under the scheme of incorporation did not reveal an abnormality, reference was made to the summarization of the tax avoidance provision[12] by Chief Justice Ogilvie Thompson in *Secretary for Inland Revenue v. Geustyn, Forsyth & Joubert.*[13] According to this summarization, the application of the provision presupposes:

(a) a transaction, operation or scheme entered into or carried out;
(b) which has the effect of avoiding or postponing liability for tax on income or reducing the amount thereof; and which,
(c) in the opinion of the Secretary for Inland Revenue, with regard to the circumstances under which the transaction, operation or scheme was entered into or carried out –
  (i) was entered into or carried out by means or in a manner which would not normally be employed in the entering into or carrying out of a transaction, operation or scheme of the nature of the transaction, operation or scheme in question; or
  (ii) has created rights or obligations which would not normally be created between persons dealing at arm's length under a transaction, operation or scheme of the nature of the transaction, operation or scheme in question; and that
(d) the avoidance, postponement or reduction of the amount of such liability[14] was, in the opinion of the Secretary, the sole or one of the main purposes of the transaction, operation or scheme. Once it is proved that the transaction, operation or scheme in issue would result in the avoidance, postponement or reduction of tax, it is, until the contrary is proved, presumed that the sole purpose was the avoidance, postponement or reduction of tax. Subject to this presumption, all the four requisites must co-exist in order to justify the Secretary in invoking the provision.

As held in *Ovenstone v. Secretary for Inland Revenue,*[15] even if the purpose or effect of a scheme when formulated was not to avoid tax liability, it may have that effect or that may become one of the taxpayer's main purposes when he subsequently implements the scheme. In such a case, the tax avoidance provision becomes applicable, provided the other requirements are fulfilled. Finally, since the tax avoidance provision is clearly directed at defeating tax avoidance schemes, it does not impose a new tax.[16]

Double taxation agreements

In an increasing number of instances, the Republic of South Africa has entered into double taxation agreements with other countries. These agreements relate either to income in general or are confined to sea and air transport. General income tax treaties have been concluded with:
Botswana, Bophuthatswana, Canada, Ciskei, Gambia, Grenada, Mauritius, Seychelles, Sierra Leone, Federal Republic of Germany, Israel, Lesotho, Malawi, the Netherlands, South West Africa, Swaziland, Sweden, Switzerland, Tanzania, Transkei, Uganda, the United Kingdom and Northern Ireland, the United States of America, Venda, Zambia and Zimbabwe.
Sea and air transport treaties exist with:
Belgium, Brazil, China, Denmark, Finland, France, Greece, Ireland and Italy.

BRIEF REVIEW OF THE MAJOR CHANGES

Abolition of provincial income tax

The provincial income tax is abolished in 1957 for companies and 1971 for natural persons.

Abolition of super tax

The super tax, previously payable by individuals, was abolished in 1960.

Abolition of apportionment system

In 1952 the apportionment system was abolished with one exception. When the shareholder was a company not registered nor carrying on business in the Union, then the apportionment system was retained for the purposes of the non-resident shareholders' tax. In 1961 the apportionment system was completely abolished; private companies were not subject to the flat rate.

9. 1946 AD 441.
10. Ibid., at 450, per Watermeyer CJ.
11. 1983(3) SA 551 (A) (unanimous), per Corbett JA, at 575C.
12. Ibid., at 568-9. The Secretary for Inland Revenue there referred to is now the Commissioner for Inland Revenue.
13. 1971(3) (A) SA 567 (A) (unanimous), at 571E-572A.
14. The extension to any other law administered by the Commissioner for Inland Revenue in the Income Tax (Amendment) Act No. 121 of 1978 will be discussed later.
15. 1980(2) SA 721 (A) (unanimous), at 732D, E, per Trollip JA.
16. *Glen Anil Development Corporation Ltd. v. Secretary for Inland Revenue* 1975(4) SA 715 (A), at 727H, per Botha JA.

Decedent's estate

Since 1961, "person" includes the estate of a deceased person.

Abatements v. rebates

Because a person's ability to pay tax decreases according to the size of his family, medical expenses, etc., the State has assisted the taxpayer either by granting rebates equal to the tax or by providing abatements of the taxable income. An abatement seems to be a greater concession than a rebate as marginal rates rise. If, however, the abatement is reduced as income increases, it will not unduly favor the higher income groups. The system of abatements prevailed from 1914 to 1940, to be replaced, in 1941, by one of rebates. The 1971 Income Tax Act reinstated the system of abatements, but, since 1980, the system of rebates has prevailed again.

Fringe benefits

The Income Tax Act No. 121 of 1984 amended the Income Tax Act No. 58 of 1962 to include a schedule dealing with benefits or advantages derived by reason of employment or the holding of any office. This schedule is known by the more popular titles: Perks, Fringe Benefits or Remuneration In Kind. The schedule aims to establish uniform rules for the determination of the value in question and equal treatment for all regardless of status, standing or the nature of the respective offices or employment. The cost to the employer is the basis for the valuation of benefits in kind, and no value may be placed on certain less cost-effective benefits.

Tax avoidance

The requisite purpose of the avoidance or the postponement of liability for the payment of any tax, duty or levy imposed by the Income Tax Act or the reduction of the amount of such liability has been extended under the Income Tax (Amendment) Act No. 121 of 1978 to any other law administered by the Commissioner for Inland Revenue – that is the Estate Duty Act, Transfer Duty Act, Stamp Duty Act, Marketable Securities Act and Sales Tax. Furthermore, the Income Tax (Amendment) Act No. 121 of 1984 extends the tax avoiding section (Section 103 of the Income Tax Act No. 58 of 1962, as amended) to close corporations.

Amounts to be deducted or withheld by employers and provisional payments in respect of normal tax

Prior to 1 March 1963, income tax in South Africa was paid on the income of the previous year.

The current system, "pay-as-you-earn" (PAYE), was proposed as early as 1955, but did not become law until 1 March 1963. It works as follows:

In the case of employees, as defined, the employer withholds from the employee's remuneration certain amounts calculated in accordance with the deduction tables. These sums are paid to the Commissioner for Inland Revenue within a certain time. This tax is referred to as the employees' tax.

Persons who are not within the definition of employees pay a provisional tax. The tax is ordinarily payable in two installments: one half of the estimated tax liability for the year in question which must not be lower than that reflected in the last assessment is to be paid between the last day of February and the 31st of August and the other half is to be paid not later than the last day of February. In some instances a third installment may be required. Beginning with the 1986 tax year, taxpayers over the age of 65 whose taxable incomes do not exceed R20,000 per annum and who are not directors of companies nor derive income from a trade, business, profession or farming, are exempted from the obligation to pay provisional tax.

Further appeal to Supreme Court

Judgements rendered by the special court before 8 October 1976 for hearing income tax appeals could be appealed only on a question of law by way of a stated case. An appeal lies now on both fact and law. The requisite procedure has also been simplified.

Undistributed profits tax

In 1951 the undistributed profits tax was abolished. In 1955 the tax was reinstated for public companies and extended to private companies as well; although abolished again for public companies in 1960, the undistributed profits tax was later reimposed on dividends and foreign income of public companies in 1969. The present position may be summarized as follows:

The undistributed profits tax is calculated on the amount by which the distributable income of the company exceeds the amount of the dividends distributed by it during the specified period at the rate of 33⅓% of the distributable balance. Only companies which are South African or carry on business in the Republic may be liable for undistributed profits tax. Certain companies are exempt, including: associations beneficial to the public, close corporations (which will be dealt with below), companies with foreign shareholders, non-Republic companies carrying on business in the Republic, companies whose reserves do not exceed R50,000 or 40% of the paid-up capital, and companies whose profits do not exceed 5% of the paid-up capital.

Non-resident shareholders' tax

As a result of the apportionment system (see above), the liability for the non-resident shareholders' tax was enlarged in 1960 and 1961. As its name implies, the tax is levied on a non-resident shareholder of a company of the Republic or of a company carrying on business in the Republic. With regard to holders of bearer script, however, they need not be residents outside the Republic. The tax which is effective from 22 March 1967 amounts to 15% of the dividend in question, the taxpayers' ability to pay being irrelevant. Many exceptions, exemptions and restrictions prevent the seemingly far reaching definitions of "company" and "dividend" from attracting the tax in all instances.

Close corporations

Close corporations, introduced by the Close Corporations Act, No. 69 of 1984, effective 1 January 1985, are meant for smaller businessmen. While close corporations are considered legal entities the relationship between their members and creditors is akin to a partnership. Close corporations are taxed in the same manner as companies with 2 exceptions. First, dividends received by the close corporation are taxed while in the corporation's possession, but are subject to the deduction of one-third thereof (like in the case of an individual). Second, dividends distributed to the shareholders by the close corporation will not be taxable. However, while dividends declared by a close corporation will not be subject to normal tax, they will be subject to a non-resident shareholders' tax if the member is not ordinarily resident in the Republic.

Where a company at any time during the year of assessment is converted into a close corporation or vice versa, it is regarded for assessment purposes as a close corporation for the full year. If at the end of the assessment period preceding the date of conversion a company which has been converted into a close corporation has profits which would have constituted dividends had been distributed to the shareholders by way of a liquidation dividend, the company is deemed on the date of conversion to have made a distribution of such profits to the corporation and the corporation is subject to normal tax on such amount. The rate of tax will be limited to 10% and will be determined separately without taking into account assessed losses.

Gift tax

Prior to 1955 a taxpayer could reduce his income tax by donating a portion of his estate and spreading his income over a number of taxpayers. If the donor taxpayer survived 5 years after the gift, his estate was reduced for death duties. In 1955 donations tax was introduced as part of the Income Tax Act, and the time limit during which donations attracted death duties was removed. The donations tax is levied on the cumulative taxable value of all property given directly, indirectly or in trust, by a person ordinarily resident in the Republic or by a company (including a close corporation) registered, managed or controlled in the Republic. A donation includes not only gratuitous transfers of property and waivers or renunciations of rights, but also transfers of property for a consideration which, in the opinion of the Commissioner for Inland Revenue, is inadequate. Of the many exemptions, the following may be mentioned:

The donations tax is not levied/assessed on property given by the donor to, or for the benefit of, his spouse who is not separated from him (as the Act still reads: "under a judicial order or notarial deed of separation"). Gifts to a spouse under a contract (antenuptial, postnuptial or in terms of the Matrimonial Property Act No. 88 of 1984[17]) are also exempt.

Casual gifts not exceeding R5,000 per annum (subject to certain special provisions) are exempt as are gifts to or for the benefit of the donor's children, provided they do not exceed the sum arrived at by multiplying R20,000 by the number of children of the donor who are alive on the date of donation (subject again to certain special provisions). Bona fide maintenance payments which appear to the Commissioner for Inland Revenue to be reasonable are also exempt.

The tax is at progressive block rates, the block exceeding R90,000 being taxable at the rate of 25%. The donor is liable for the tax; however, if he fails to pay the tax within the prescribed period (ordinarily 3 months), he and the donee become jointly and severally liable for the tax.

Non-residents tax on interest

In 1967 the Legislature introduced a non-residents tax on interest. This is a tax of 10% on interest accruing to any natural person or the estate of any person who, at his death, was not a resident of the Republic. Where such interest is also subject to normal tax, the taxpayer enjoys a rebate of the non-residents tax on interest not exceeding the normal tax attributable to that interest.

Exemptions from the non-residents tax on interest include: interest from the Government, the South African Transport Services, the provincial administrations, local authorities, the Local Authorities Loan Fund, the Electricity Supply Commission, the South African Reserve Bank, the South African Broadcasting Corporation, and the Development Bank of Southern Africa. Other exemptions apply to interest on money borrowed outside the Republic and not used or intended to be used for the purpose of producing gross income, and interest payable in the Republic on money lent therein by a person who has a permanent place of business in the Republic. Finally, interest on any bill of exchange or promissory note for the purchase price of goods imported into the Republic, provided the bill or note has been certified through a registered banking institution or the South African Reserve Bank.

17. See Meyerowitz and Spiro *The Taxpayer's Permanent Volume on Income Tax* (loose-leaf) §1655.

PEOPLE'S REPUBLIC OF CHINA: New Provisions Encouraging Foreign Investment

By Charles D. Toy*

The State Council of the People's Republic of China promulgated on 11 October 1986 new Provisions for the Encouragement of Foreign Investment (the "Foreign Investment Provisions"), effective on the date of promulgation.

Intended to address some of the problems voiced by foreign investors in China, the Foreign Investment Provisions cover a range of matters and are applicable in part to all Chinese-foreign equity joint ventures, Chinese-foreign cooperative ventures and wholly foreign-owned enterprises (collectively called "Enterprises with Foreign Investment" under the Foreign Investment Provisions). Certain of such Enterprises with Foreign Investment are specially identified and receive more preferential treatment. In particular, production enterprises whose products are in the main exported and which have foreign exchange surpluses (after deduction of all foreign exchange expenditures and remittance abroad of profits) are defined as "Export Enterprises", and production enterprises supplied with advanced technology by the foreign investors thereto and engaged in developing new products or upgrading and replacing products, resulting in generation of foreign exchange, are defined as "Technologically Advanced Enterprises".

Express benefits of the Foreign Investment Provisions include new guidelines for Enterprises with Foreign Investment in areas such as compensation for staff and workers, land use fees, utilities and service fees, short-term financing, income and other taxation, export and import licensing, foreign exchange, bureaucratic delays and Government intervention, and independence of management. Specifically:

- Export Enterprises and Technologically Advanced Enterprises are exempted from the payment of subsidies heretofore required to be paid to Chinese staff and workers, except that funds must still be paid and/or set aside to pay for labor insurance, welfare costs and housing subsidies for such staff and workers. This exemption should lower labor costs for eligible Enterprises with Foreign Investment, although labor insurance, welfare and housing subsidy payments typically constitute the largest amounts, other than basic wages, in compensation paid to Chinese labor.
- Land use fees for Export Enterprises and Technologically Advanced Enterprises outside "busy urban sectors of large cities" are fixed at relatively low levels – 5 to 20 RMB[1] per square meter per year, or as little as 3 RMB per square meter per year where "development fees" are paid or covered separately. The exception for ventures in urban areas will exclude many enterprises from the scope of benefits granted, but the use of express amounts in the discussion of land use fees payable will give much clearer guidance to eligible ventures in calculating land use costs and, just as importantly, in determining the means by which to finance such costs.
- Export Enterprises and Technologically Advanced Enterprises are given priority in obtaining water, electricity, transportation services, and communication facilities needed for production and operation. Furthermore, fees charged for such utilities and services are to be computed "in accordance with the standards for local state enterprises". It should be noted that the Regulations for the Implementation of the Law of the People's Republic of China on Joint Venture Using Chinese and Foreign Investment (the "Joint Venture Implementing Regulations") already provide for the lower level of fees for all Chinese-foreign equity joint ventures.
- Export Enterprises and Technologically Advanced Enterprises are given priority in respect of loans for short-term working capital needs, a new benefit for eligible enterprises.
- Export Enterprises and Technologically Advanced Enterprises are not subject to the 10% tax on repatriation of profits by foreign joint venture partners, which is a new benefit for such enterprises located outside of the Special Economic Zones (the Special Economic Zones have provided the same benefit to all Enterprises with Foreign Investment since 1984).
- Export Enterprises which export 70% or more of their products in any tax year may pay income tax at one-half the normal rate. For eligible Chinese-foreign equity joint ventures, this special benefit appears to provide an indefinite extension of the 3-year, 50% reduction already allowed under current law.
- Export Enterprises in the Special Economic Zones or Economic and Technological Development Zones eligible to pay income tax at the maximum rate of 15% may pay income tax at a maximum rate of only 10%, provided that they export 70% or more of their products in the respective tax year.
- Technologically Advanced Enterprises are granted a flat 3-year period of payment of income tax at one-half the normal rate, commencing on expiration of any exemption or reduction period for which such enterprises are eligible under current law (Chinese-foreign equity joint ventures are usually eligible for a 2-year income tax holiday, followed by a 3-year reduction of income tax rates at one-half of the normal rates, all commencing with the first profit-making year).

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1. RMB is a Chinese monetary unit. RMB is a phonetic translation of the name of the monetary unit of the People's Republic of China. This monetary unit is approximately 3.7 RMB to US$1.

- Foreign investors reinvesting, for not less than 5 years, profits which otherwise might be remitted outside China will be given a refund of income taxes paid on reinvested amounts. This is an expansion of the concept already included in the Joint Venture Income Tax Law, which provides that 40% of such reinvested amounts will be refunded to the foreign investor in the respective Chinese-foreign equity joint venture.
- Most export products of Enterprises with Foreign Investment are exempted from the Consolidated Industrial and Commercial Tax. The Joint Venture Implementing Regulations provide a similar benefit, subject only to Ministry of Finance approval, for Chinese-foreign equity joint ventures.
- Import license requirements are lifted for Enterprises with Foreign Investment importing machinery and equipment, production vehicles, raw materials, fuel, bulk parts, spare parts, component parts and fittings needed to carry out export contracts. This simplification of procedures may be beneficial to eligible Enterprises with Foreign Investment, but appears difficult to implement in the case of all such enterprises which produce not only for export but for domestic sale in China as well, since the necessary allocation of imported goods or materials (between those to be used in export production and those to be used in production for domestic sales) is not likely to be obvious at the time of import.
- Enterprises with Foreign Investment may, under the supervision of foreign exchange control departments, adjust foreign exchange surpluses and deficits among each other. This provision assumes the existence of enterprises with foreign exchange surpluses willing to enter into adjustment arrangements. Such enterprises may exist, but perhaps not in sufficient numbers or with surpluses adequate to solve the foreign exchange problems of any substantial number of other enterprises.
- Relevant examination and approval authorities are required to render decisions with respect to the approval of Enterprises with Foreign Investment within 3 months from the date of receipt of documents submitted for approval. This mandate reiterates an almost identical provision set forth in the Joint Venture Implementing Regulations and applicable to all Chinese-foreign equity joint ventures.
- Enterprises with Foreign Investment are expressly granted the right to determine their own production and operation plans, to raise and use funds, to purchase production materials, to sell products, to determine the forms and levels of wages, bonuses and allowances for their employees, to determine their organizational structure and personnel system, to employ or dismiss senior management personnel, to increase or dismiss staff and workers, and to recruit and employ technical and managerial personnel and workers in their respective localities. Local districts and departments are also called upon to curb the indiscriminant levy of charges on enterprises, and Enterprises with Foreign Investment that do encounter unreasonable charges are permitted to refuse payment and to appeal any such charges, right up to the State Economic Commission.
- Enterprises with Foreign Investment qualifying for the particular benefits applicable only to Export Enterprises or Technologically Advanced Enterprises must be so certified, by both the foreign economic and trade departments where such enterprises are located and other relevant departments. Such certification can apparently be obtained on the basis of anticipated circumstances, but failure actually to qualify as an Export Enterprise or a Technologically Advanced Enterprise will result in a requirement that the respective Enterprise with Foreign Investment make up in the relevant following year all taxes and fees inappropriately reduced or exempted.

The Foreign Investment Provisions give evidence that China's State Council is serious about improving investment conditions for foreign investors in China. However, the thresholds of eligibility for many of the new benefits provided may be so high as to give the Foreign Investment Provisions little practical effect. Moreover, as with many new laws, regulations and provisions designed to encourage new or continued investment activity, the true test of effectiveness is not in the substance of the benefits outlined, but in the implementation of what often appears to be already clear and express language in the respective legislation itself. The reiteration of certain benefits already available to certain kinds of Enterprises with Foreign Investment underscores the reality that some such enterprises are not now receiving benefits to which they are presumably entitled.

Perhaps just as important as the promulgation of the Foreign Investment Provisions is the formation of a special foreign investment working group, consisting of senior officials from key Central Government organizations, including the State Planning Commission, the Ministry of Foreign Economic Relations and Trade, the People's Bank of China, the State Administration for Exchange Control, and the State Administration for Industry and Commerce. The working group is supposed to establish foreign investment policies and to supervise local government implementation of such policies.

In any event, to take full advantage of the benefits set forth in the Foreign Investment Provisions, foreign investors should be prepared for detailed discussions with their Chinese counterparts in all negotiations on contracts documenting their relationship. In particular, all joint venture and other contracts should spell out concretely and carefully how the respective enterprises do or will qualify for the new special benefits provided, and specify precisely what such benefits are.

LESOTHO:

1986/87 Budget: Some Preliminary Observations

By Umesh Kumar

Professor Umesh Kumar is Dean of the Faculty of Law at the National University of Lesotho. He has been acting as Rapporteur for the International Bureau of Fiscal Documentation since 1983.

The Military Council has now approved a Budget of M463.3 million[1] for the financial year beginning 1 April 1986 to 31 March 1987. The expenditure is to be financed by the *Customs Union*[2] revenue of M147 million, individual and corporate income and withholding taxes of M24 million, sales tax of M31.3 million and miscellaneous local charges and fees of M41 million. M93.6 million are anticipated grants from foreign donors and another M50.47 are anticipated concessionary overseas loans. A deficit of M78.2 million would be covered largely by commercial borrowing from the local market.

The national debt takes M76.8 million by way of repayment of principal and interest. Education receives close to M35 million; agriculture – M16.10 million; health – M14.16 million; public works – M12.39 million; and interior – M10.62 million.

The capita (development) Budget contemplates an expenditure of M197.9 million, of which, as indicated above, M143.8 million would be covered by donor grants and concessionary loans.

The individual income tax rates remain unchanged. The Minister of Finance has acknowledged that individual taxpayers face a double jeopardy – high income tax rates and high inflation. And there has been only nominal relief. Individual abatements have been raised by Order No. 10 of 1986, which has amended several sections of the Income Tax Act, 1981. Under S.12(1) of the Act, individual abatement for an unmarried person, or for one whose income is assessed separately from that of his spouse, goes up to M1,200 (previously M600). In the case of a married person, whose income is assessed together with that of his spouse, individual abatement has been raised to M2,400 (previously M1,200). Individual abatements remain unchanged as regards children. Based on the 1975/80 population growth, Lesotho's population seems to be growing at a rate of 2.077% per annum. The employment opportunities, including the ones in South Africa, are not keeping pace with the population growth. Some studies[3] show that they may indeed decline in future. Therefore, one would have thought that the Government would grant suitable tax incentives to implement its national policy regarding spacing of births between one child and the subsequent ones. In any case, there appears to be no justification for failing to increase abatements in respect of dependent children. However, as regards other dependents, individual abatements have been increased. The abatement goes up to M180 (previously M120), for each dependent subject to a maximum of M540 (previously M360). S.6(3), which basically affects low income groups, has also been amended to provide some relief. After abatements and other admissible deductions, if the taxable income of a person does not exceed M1,800 (previously M1,200), then he would not be liable to tax. If his taxable income exceeds M1,800, but not M2,400 (previously M1,700), he would be liable to pay tax equal to one fifth of that which exceeds M1,800. S.22(1)(i) has also been amended. The first M240 (previously M100) of interest earned on savings deposits are now exempt from income tax.

The loss of revenue caused by increasing these personal reliefs has been offset by increasing the rate of sales tax from 8% to 12%. Unlike elsewhere in the region, only flour, milk and eggs are exempt from sales tax.

The steepest increase is in the company tax rates. Companies have, for the first time, been divided into those that derive their income from manufacturing operations and those that do not. S.2 of the Act has been amended and a new definition of "manufacturing operation" has been added. "Manufacturing operation" has been defined to mean any processing operation which involves the conversion of one or more materials into a finished product. Routine assembly work and construction of buildings have been specifically excluded from the definition. While the companies engaged in manufacturing would continue to pay 37.5% of their taxable profits as tax, other non-manufacturing companies would now be subject to

1. The currency of Lesotho is the loti (plural: maloti). The country participates in the Rand Monetary Area together with Swaziland and South Africa and within this area there is no exchange control on the transfer of funds.
2. Lesotho is a member to the Southern African Customs Union together with Botswana, South Africa and Swaziland. A common external customs tariff is determined by South Africa in consultation with other members. The income from tariffs is divided over the participating countries. There are, in principle, no internal barriers to trade within the customs area.
3. See Kizilyalli, *Options for the Lesotho Economy in the Year 2000: Perspective Plan Alternatives*, 1982, and the *Third Plan Preview*, Oct. 1979. Both are unpublished studies of the Government of Lesotho.

45% (previously 37.5%) of tax on their profits. It is a moot question whether this would indeed encourage setting up of more manufacturing industries in Lesotho.

Withholding tax provisions have been amended too. Up until now, only non-residents (as defined in the Act) were subject to withholding tax under S.90 of the Act. The section has now been further tightened to prevent evasion, but there has been no change in the withholding tax rates, so far. The Minister of Finance, however, has indicated in his Budget Speech that henceforth even residents' income shall be subject to a compulsory tax deduction. Legal Notice 51 of 1986 requires the Financial Institutions to deduct 10% of the interest in excess of M240 on savings and deposit accounts. It may mean, in practice, some inconvenience to those residents who are not otherwise liable to tax. They would now have to submit tax returns to get a refund. The Government shall also deduct 10% from the contract payments of any kind, whether made under foreign aid agreements or to transport and construction contractors or anyone else.

COMMENTS

The Budget is inflationary. The fuel rates in Lesotho are about 5% higher than in the Republic of South Africa (RSA). Further, compulsory third party insurance payments are not required in the RSA. Since Lesotho is landlocked and depends heavily on road transport, one wonders whether high fuel rates and third party insurance payments are not contributing to hardships and inflation. The rise in company tax rates for trading and other non-manufacturing companies' profits would ultimately come out of the pockets of the consumers and add to the inflation. The steep sales tax, which does not exempt fresh vegetables, fruits, butter, cooking oil, margarine, fresh meat, fish and sugar, is both inequitable and inflationary. Sales tax affects the poor the most. The marginal reliefs offered in the Budget to consumers do not compensate the common man. His total tax and inflation burden is far more than what it was in the last financial year.

There has been a drop of M17 million in the Customs Union revenue. If the newspaper reports are to be believed, they are likely to fall further in coming years. The South African Government is reported to have under its consideration a revision of the Customs Union agreement that would de-emphasize the revenue distribution aspects of the treaty.

In December 1984, a "final joint draft" of a treaty was prepared by the Lesotho and South African experts to provide a framework for constructing and operating, what is known as The Highlands Water Project. It involves harnessing and sale of the waters of Lesotho's Senqu river to South Africa, as well as, generating hydro-electric power, which may make Lesotho almost entirely self-sufficient as regards her electricity needs, besides generating substantial revenue from water sales. The project would cost roughly R2.3 billion and would be largely donor-financed. The Highlands Water Project has apparently run into difficulties due to the South African insistence that the "joint draft" of the treaty earlier prepared be reviewed. The exercise has not yet been completed. The delays may affect the financing of the project and the project revenues. It is, thus, necessary that a fresh thought be given to such revenue generating projects that would have a short gestation period.

The depreciation of the rand has added to the woes of the Government. The hard currency component of the national debt has ballooned because the rand has fallen in value. Part of the increase in the payment of interest and principal on the national debt is certainly due to this fall. Moreover, many of the donor projects require Lesotho to provide a matching maloti expenditure. A fall in value of the rand adds to the loti that would have to be provided. One does not know the extent to which the raising of taxes has contributed directly to the fall in the value of the rand. Both Botswana and Swaziland left the Rand Monetary Area because of the adverse effects that the fall in the value of the rand was having on their economies. One does not know whether this option was considered by the Military Council as a way to curb inflation, limit deficit financing and increase taxes.

The Government is rightly worried about the evasion of taxes. Professionals and businesses are often singled out as the black sheep. However, it is well known that high tax rates and unfair tax administration encourage tax evasion. It is also well known that measures that encourage voluntary compliance are most cost-effective to raise the collection of taxes. It appears to us that it is high time that the Government appoints a task force to look into the whole tax and monetary structure and its implications for the economic development of Lesotho.

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LIST OF AUTHORS 1986

INDEX 1986

I. ARTICLES:

II. REPORTS AND DOCUMENTS

III. IFA NEWS

IV. CONFERENCE DIARY

V. BIBLIOGRAPHY