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

Art. 2 – Objects

1. The objects of the foundation shall be to organise and maintain a documentation centre for the purpose of providing information about and explanations of national and international taxation and the application thereof, as well as promoting the study of taxation in general.
2. In the realisation of its objects the foundation shall strive to maintain good co-operation with its founder, the International Fiscal Association, hereinafter referred to as "I.F.A.", which set up the foundation as an independent entity.

Art. 3

1. The foundation shall endeavour to achieve its objects:
   a. by collecting and maintaining information concerning taxation whether in the form of a library with relevant books, periodicals and other publications, a data base or in any other form;
   b. by providing information and explanatory information;
   c. by providing the opportunity, with the permission of the Board

L'OBJET DU BUREAU

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

Art. 2 – Objets

1. La fondation a aussi bien pour objet d'organiser et de tenir à jour un centre de documentation permettant de fournir des informations et explications sur la fiscalité nationale et internationale et son application, que de promouvoir l'étude de la fiscalité en général.
2. Pour la réalisation de ces objets, la fondation devra chercher à entretenir une bonne coopération avec sa fondatrice, l'Association Fiscale Internationale, ci-après intitulée I.F.A. (International Fiscal Association), qui a créé la fondation comme entité indépendante.

Art. 3

1. La fondation s'efforcera pour la réalisation de ces objets:
   a. de rassembler et tenir à jour les informations portant sur la fiscalité soit sous la forme d'une bibliothèque possédant les livres publiés dans ce domaine, les périodiques et autres publications, soit sous la forme d'une banque de données, soit sous une autre forme;

of Directors and subject to the conditions laid down by the Board of Directors, which may also be of a financial nature, of making use of the information stored and having access to the works present in the library;
d. by publishing;
e. by offering co-operation in the publication of third parties;
f. by all other lawful means.

2. Within the framework of its objects the foundation shall be entitled to set up other legal entities and organisations or participate therein, whether on its own or together with others.

b. de fournir des informations et explications;
c. d'offrir la possibilité, avec la permission du Directoire et suivant ses conditions, celles-ci pouvant également être de nature financière, d'utiliser les informations rassemblées et d'avoir accès aux ouvrages disponibles dans la bibliothèque;
d. de publier;
e. d'offrir sa coopération dans la publication de tiers;
f. d'utiliser tout autre moyen légal.

2. La fondation est autorisée, dans le cadre de ses activités, à créer d'autres entités légales et organisations, d'y avoir une participation que ce soit seule ou en collaboration avec d'autres.

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

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

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

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

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

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

Guides to European Taxation, également une publication sous feuilles mobiles, comprend "The Taxation of Patent Royalties, Dividends, Interest, in Europe", "The Taxation of Companies in Europe", "The Taxation of Private Investment Income", "Value Added Taxation in Europe" et "Taxation in European Socialist Countries".

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The I.F.A. was founded on the 12th of February 1938 by tax experts of a number of countries. Purpose and working-method are defined as follows in the Articles:

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

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

I.F.A. has branches in 36 countries. Residents in any of these countries (I.F.A. members or candidates for membership) can approach the secretary of the local Branch.

Members who live in countries where I.F.A. has no Branch are registered as direct members of the Association. They can get in touch with the General Secretariat of I.F.A. (this also applies to candidates for membership).

Conditions of direct membership of I.F.A. for 1988 are: individuals US$ 45.– p.a.; corporations US$ 100.– p.a.

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J.C. Holland:

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COLOMBIA: IMPORTANT TAX REFORM PROPOSED BY GOVERNMENT 36

In the wake of the recent U.S. tax reform, the new Colombian President, Virgilio Barco, has supported major tax reform legislation. This new legislation is expected to result in a flat corporate tax rate, simplification of the personal income tax with reduction in the rates, and an increase in the VAT rate. Provisions effecting foreigners are also planned. The author presents a summary of the major changes expected.

Charles Cain:

THE ISLE OF MAN: YOUR "USER-FRIENDLY" OFFSHORE CENTRE 37

This article is an overview of the possibilities and advantages the Isle of Man offers as an offshore financial centre.

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Richard Hammer und William D. Rohrer:

Die Besteuerung der Zweigniederlassungen in den USA – Unterfangen mit ungewissem Ausgang 3

Die Verfasser vermitteln eine gründliche Darstellung der neuen Steuer, die auf der Stufe der Zweigniederlassungen erhoben wird. Sie zeigen die wichtigsten, mit Unsicherheitsfaktoren belasteten Gebiete auf. Diese Gebiete erstrecken sich sowohl auf die Anwendung der neuen Gesetze bezüglich der Behandlung von Dividenden und Zinsen, als auch auf den Schutz, der sich aus den verschiedenen Nichtdiskriminierungsklauseln ergibt. Schliesslich vermitteln Herr Hammer und Herr Rohrer dem Leser einen Überblick über alle zur Zeit bestehenden Doppelbesteuerungsabkommen der USA.

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A.H. Qureshi:

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J.C. Holland:

Das Wesen der Mehrwertsteuer 23
Der Verfasser hat sich seit geraumer Zeit mit der Wissensvermittlung zu den Auswirkungen der Mehrwertsteuer beschäftigt. In diesem kurzen Artikel zeigt er Aspekte auf, die seiner Meinung nach durch die Mehrwertsteuer nicht in ausreichendem Masse berücksichtigt werden; ferner nennt er Beispiele, von denen er glaubt, dass die Mehrwertsteuer zu Verschwendung führt.

Estudio Martinez, Bellido, Berninzon & Lavalle:

Peru: Niederlassungen ausländischer Gesellschaften – Die steuerliche Behandlung des Einkommens und Vermögens – 29
Die Autoren vermitteln einen Überblick über die beiden wichtigsten Steuern, die in Peru auf das Einkommen der Niederlassungen ausländischer Unternehmen veranlagt werden; dabei handelt es sich um die Einkommen- und die Vermögensteuer. Ferner geben sie eine Definition der betroffenen Rechtsträger und des zu besteuernden Einkommens.

G.A. Nezis:

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James Leavy:

Kolumbien: Regierung schlägt wichtige Steuerreform vor 36
Im Kielwasser der kürzlichen US-Steuerreform hat der Präsident von Kolumbien, Herr Virgilio Barco, eine Gesetzesvorlage für eine umfassende Steuerreform befürwortet. Es ist zu erwarten, dass die neue Gesetzgebung einen Einheitssteuersatz für die Körperschaftsteuer, eine Vereinfachung der Bestimmungen zur Einkommensteuer mit gleichzeitiger Senkung der Steuersätze und eine Erhöhung des Mehrwertsteuersatzes vorsieht. Für Ausländer sind ebenfalls neue Bestimmungen vorgesehen. Der Verfasser vermittelt eine Zusammenfassung der wichtigsten zu erwartenden Gesetzesänderungen.

Charles Cain:

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J.C. Holland:

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James Leavy:

Colombie: Importante réforme fiscale présentée par le Gouvernement 36
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Charles Cain:

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Edgar Naranjo L.:
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Neue Bestimmungen des Companies Act 1986 sind in Kraft getreten.

Jean-Marc Tirard:
Algerien: Die Besteuerung ausländischer Gesellschaften 51
Der Verfasser vermittelt einen Einblick in die Arbeitsweise des algerischen Steuersystems für ausländische Gesellschaften, die in Algerien investieren wollen. Er untersucht das Konzept der joint ventures, wobei er die Vor- und Nachteile der Markterschliessung mittels dieser Form aufzeigt. Herr Tirard beendet seinen Beitrag damit, dass er einige der steuerlichen Vorteile unter dem Doppelbesteuerungsabkommen zwischen Frankreich und Algerien erläutert.

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A.H. Qureshi:
Die Unitary Taxation und das allgemeine internationale Recht 56
Dr. Qureshi stellt seine Auffassung zur Rechtmässigkeit der Unitary Taxation im Licht des allgemeinen internationalen Rechts dar. Dieser Artikel baut auf seinem Artikel im Januar-Heft des Bulletin auf, wo er die Grenzen des Besteuerungsrechts im internationalen Rahmen absteckte.

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Jitendra R. Modi:

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Der Verfasser vermittelt einen Überblick über die Körperschaftsteuersysteme von 32 Entwicklungsländern. Dabei bespricht er sowohl die Abschreibungsmethoden als auch die Steuersätze, die Steuerbefreiungen als auch die Behandlung der Veräusserungsgewinne in diesen Ländern. Im letzten Abschnitt seines Artikels erläutert Herr Modi die Besteuerung der Dividenden.

Bilaterales Abkommen zwischen Dänemark und Schweden zur Ergänzung des multilateralen Abkommens der nordischen Staaten zur Vermeidung der Doppelbesteuerung des Einkommens 74
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Edwin A. Vella:

Das Doppelbesteuerungsabkommen zwischen Malta und Lybien – Die Möglichkeit der Inanspruchnahme von Vorteilen auf ungewohnten Gebieten? 75
Herr Vella informiert den Leser über verschiedene steuerliche Vorteile nach dem einzigen Doppelbesteuerungsabkommen, bei dem Lybien derzeit Vertragspartner ist. Er erläutert die Vorteile bei der Schifffahrt, die Vorteile, in deren Genuss die Familien ausländischer Arbeiter in Lybien kommen können, das Anrechnungssystem des Doppelbesteuerungsabkommens sowie andere Vorteile, die dieses einmalige Vertragsverhältnis anzubieten hat.

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Har Govind:

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Die ungeheure Verschwendung von Energie kann durch steuerliche Massnahmen positiv beeinflusst werden. Die USA haben bereits gesetzliche Bestimmungen zu diesem Gebiet verabschiedet. Herr Govind erläutert einige der Methoden, die in Indien angewandt werden können, um den Energiekonsum zu drosseln.

Edgar Naranjo L.:

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Der Verfasser erläutert einige der Fundamente des Abkommens von Cartagena. Er stellt die Zielsetzungen dar und bespricht die abweichende Haltung von Ecuador und Bolivien. Herr Naranjo kommt zu dem Schluss, dass die Abkommensstaaten die gesteckten Ziele nicht erreichen und dass das Abkommen revisionsbedürftig ist.

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L'auteur résume les systèmes fiscaux applicables aux sociétés dans 32 pays en voie de développement. Il commente les différents taux applicables ainsi que les amortissements, les suspensions d'imposition et le traitement des plus-values dans ces différents pays. Dans la seconde partie de son article, M. Modi commente l'imposition des dividendes.

Accord bilatéral entre le Danemark et la Suède complétant la convention fiscale multilatérale nordique sur les impôts sur le revenu 74
Cet accord bilatéral porte sur l'imposition des travailleurs frontaliers et remplace les dispositions de l'ancien traité qui étaient jusqu'alors applicables.

Edwin A. Vella:

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Har Govind:

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L'immense gaspillage d'énergie peut être freiné par des mesures fiscales novatrices. Les Etats-Unis ont déjà leur législation à ce sujet. Monsieur Govind mentionne quelques-unes des méthodes pouvant être valables en Inde pour une meilleure réglementation de la consommation d'énergie.

Edgar Naranjo L.:

Le Pacte andin 89
L'auteur mentionne quelques-uns des fondements de l'Accord de Cartagène. Il énonce les buts poursuivis et les positions particulières de l'Equateur et la Bolivia. Monsieur Naranjo constate en conclusion que le Groupe n'a pas atteint les buts proposés et que l'Accord doit être modifié.

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Isle of Man: Your "User-Friendly" Offshore Centre

By Charles Cain

NEW PROVISIONS ENACTED

Many of the provisions of the Companies Act 1986 came into force on the 1st January 1987, after the above article was written. However, the sections relating to the abolition of the need for a company to have any objects in its Memorandum of Association have not yet come into force. The sections that relate to the abolition of the requirement for a private company to restrict the transferability of its shares and to limit its members to not above 50, have come into force. As a result, private bearer share companies can now be formed in the Isle of Man. Such companies will provide total anonymity for their beneficial owners, and total confidentiality in relation to their accounts and activities.

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SINGAPORE: TAX INCENTIVES TO BECOME A FINANCIAL CENTRE **103**

Mr. Lee has distilled the salient points concerning tax incentives in Singapore from his extensive research manuscript to provide a view of the fiscal methods in use to induce financial growth. This article discusses the tax incentives as well as disincentives and concludes with a list of non-tax methods of spurring Singapore's growth as a financial centre.

Torao Aoki:

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Surendra Bhargava:

INDIA–CANADA TREATY FOR THE AVOIDANCE OF DOUBLE TAXATION **117**

The author provides a brief overview of the major articles in the India–Canada tax treaty concluded on 16 September 1986. Working from the U.N. Model for developing countries, these two nations have forged a new treaty designed to fairly define taxing jurisdiction.

Christian Laroche:

TWISTS AND TURNS IN THE TAX RULES FOR FOREIGN COMPANIES OWNING REAL ESTATE IN FRANCE **120**

In 1977 French tax law started to occupy itself with non-resident companies owning real property in France. Such companies were often used by residents of France as tax shelters to hold real property which was then placed at the disposal of their shareholders. In 1977 a special corporate income tax was introduced at the rate of 50% on 3 times the annual rental value of the property. This measure, however, proved to be ineffectual and in 1983 it was replaced by a 3% annual wealth tax on the value of the property. At the same time taxpayers could opt for the payment of a 15% "exit" tax if the property was transferred to the direct owners.

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ZIMBABWE: INVESTMENT BY FOREIGN COMPANIES . **137**

This article discusses the effects of the Income Tax Act, the Capital Gains Tax Act, and the U.K.–Zimbabwe Double Taxation Treaty upon different investments. Mr. Murphy provides examples of the effects of these tax Acts and treaty on dividends, interest and royalties while indicating some of the favoured sectors in the Zimbabwean tax system.

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James Leavy:

COLOMBIA: TAX REFORM ADOPTED BY CONGRESS .. **142**

The author briefly describes some important tax amendments which were recently adopted by Congress.

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Lee Fook Hong:

Steuerliche Massnahmen zur Stärkung der Position Singapurs als Finanzzentrum *103*

Herr Lee hat die wichtigsten Punkte bezüglich der steuerlichen Förderungsmassnahmen aus seinem umfangreichen Forschungsbericht zusammengefasst, welche die Position Singapurs als Finanzzentrum stimulieren sollen. Dieser Artikel beleuchtet sowohl die steuerlichen Vorteile und Nachteile, um schliesslich eine Liste von Massnahmen nicht-steuerlicher Art anzuschliessen, die das Wachstum Singapurs zu einem leistungsstarken Finanzzentrum abrunden sollen.

Torao Aoki:

Japan: Die fortschreitende Steuerreform I *111*

Der Verfasser beschreibt die Arbeit der Steuerkommission, die gebildet wurde, um einen Vorschlag für die Modernisierung des zwischenzeitlich altmodischen japanischen Steuersystems zu erarbeiten. Die Kommission beendete ihre Arbeit im Dezember 1986, und jetzt ist die Regierung damit beschäftigt, Entwürfe für die neue Gesetzgebung zu erarbeiten.

SOMMAIRE

Lee Fook Hong:

Singapour: Avantages fiscaux pouvant permettre de devenir un centre financier *103*

M. Lee analyse les points les plus importants visant les avantages fiscaux accordés à Singapour et qu'il a mentionnés dans son étude très détaillée. M. Lee souhaite donner un aperçu des méthodes fiscales utilisées afin de provoquer une croissance financière. Cet article commente les avantages aussi bien que les "désavantages" fiscaux et donne, en terminant, une liste des méthodes non-fiscales destinées à stimuler la croissance de Singapour en tant que centre financier.

Torao Aoki:

Japon: Réforme fiscale en cours I *111*

L'auteur mentionne le travail effectué par la Commission Fiscale chargée de préparer un projet de modernisation du système fiscal japonais désuet. La Commission a terminé son travail en décembre 1986 et le Gouvernement prépare actuellement la nouvelle législation.

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Surendra Bhargava:

Das Doppelbesteuerungsabkommen zwischen Indien und Kanada 117
Der Verfasser vermittelt einen kurzen Überblick über die wichtigsten Bestimmungen des Doppelbesteuerungsabkommens zwischen Indien und Kanada, das am 16. September 1986 abgeschlossen wurde. Mit dem UN-Modelvertrag für Doppelbesteuerungsabkommen zwischen Industrie- und Entwicklungsländern als Ausgangsbasis wurde ein neues Doppelbesteuerungsabkommen geschaffen, das die Besteuerungsrechte auf eine faire Weise aufteilen soll.

Christian Laroche:

Das Hin und Her in den Steuerbestimmungen für ausländische Gesellschaften mit Grundvermögen in Frankreich 120
Im Jahre 1977 begann das französische Steuerrecht damit, sich für nichtansässige Gesellschaften mit Grundvermögen in Frankreich zu interessieren. Solche Gesellschaften wurden oft von in Frankreich ansässigen Personen als Medium dafür benutzt, Grundvermögen zu halten, das dann den Anteilseignern zur Benutzung zur Verfügung gestellt wurde. 1977 wurde eine spezielle Körperschaftsteuer eingeführt, die zu einem Satz erhoben wurde, der das 3-fache des jährlichen Mietwertes des Grundstücks betrug. Diese Methode stellte sich jedoch als unbrauchbar heraus, und 1983 wurde die genannte Bestimmung durch eine neue Vorschrift ersetzt, die eine jährlich zu zahlende Vermögensteuer in Höhe von 3% des Sachwertes des Grundstücks versieht. Gleichzeitig konnten Steuerpflichtige für die Zahlung einer 15%-igen "Ausgangssteuer" optieren, wenn sie das Vermögen direkt auf die Eigentümer übertragen liessen.

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D.G. Murphy:

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Dieser Artikel erläutert die Auswirkungen des Einkommensteuergesetzes (Income Tax Act), des Gesetzes über die Besteuerung der Gewinne aus der Veräusserung von Vermögen (Capital Gains Tax Act), sowie des Doppelbesteuerungsabkommens zwischen Grossbritannien und Simbabwe bezüglich bestimmter Investitionsformen. Herr Murphy zeigt mittels einiger Beispiele die Auswirkungen auf, die die genannten Gesetze und das Doppelbesteuerungsabkommen auf Dividenden, Zinsen und Lizenzgebühren haben, wobei er auch auf günstige Bestimmungen des Steuersystems von Simbabwe hinweist.

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Surendra Bhargava:

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Christian Laroche:

Tours et détours des réglementations fiscales applicables aux sociétés étrangères possédant des biens immobiliers en France 120
En 1977 la législation fiscale française a commencé à se pencher sur la situation des sociétés non-résidentes possédant des biens immobiliers en France. Ces sociétés étaient en effet souvent utilisées par des résidents de France comme des refuges contre l'impôt afin de détenir des biens immobiliers mis à la disposition de leurs actionnaires. Un impôt spécial sur le revenu des sociétés, au taux de 50%, a été introduit en 1977 en retenant comme base d'imposition 3 fois la valeur locative du bien. Cependant cette mesure s'étant révélée inefficace, elle a été remplacée en 1983 par un impôt annuel sur la fortune de 3%, en retenant pour base d'imposition la valeur du bien. Les contribuables avaient d'ailleurs la possibilité d'opter pour le paiement d'un impôt "libératoire" de 15% lorsque le bien était transféré aux propriétaires directs.

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D.G. Murphy:

Zimbabwe: Investissements réalisés par les sociétés étrangères 137
Cet article analyse les effets sur différents investissements des lois sur l'impôt sur le revenu, l'impôt sur les plus-values et de la convention fiscale signée entre le Royaume-Uni et le Zimbabwe. M. Murphy donne les examples des effets de ces lois et convention sur les dividendes, intérêts et redevances en indiquant quelques-uns des secteurs préférés du système fiscal zimbabwéen.

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BARBADOS: INCOME TAX REFORM: AN ANALYSIS OF TWO BUDGETS IN 1986 151

The year 1986 constituted an important landmark in Barbadian fiscal history. There were two sets of budgetary proposals in April and July of this year. The July Budget proposed a comprehensive set of tax cuts unprecedented in Barbados' post-war fiscal history. This paper examines these two Budgets identifying their macro-economic implications for the economy. The paper demonstrates that, though personal income tax cuts may have a mild stimulative effect on the economy, they cannot promote production for export.

Sylvain R.F. Plasschaert:

THE WEAK CASE FOR DUALISTIC (COMPOSITE) TYPES OF INCOME TAXATION 161

The author discusses the various types of dualistic tax systems under which taxation through schedular taxes of a number of categories of taxable income is supplemented by an additional tax on total income. In the past such a system has been applied in a number of countries (for instance, France) and is still in effect in a number of developing countries, however, in these cases it is not based on a thorough theoretical analysis. It is often argued that under a dualistic tax system the disadvantages of both a schedular and a global tax system are cancelled out. The author is prepared to accept a dualistic system, for instance, during a transition period from a schedular to a global tax system.

Li Jinyan:

PEOPLE'S REPUBLIC OF CHINA: THE NEW REGULATORY TAX ON INDIVIDUAL INCOME 167

Ms. Li provides a translation and comments concerning the new Chinese regulatory income tax which became effective on 1 January 1987. This new tax applies only to resident Chinese citizens: aliens and non-resident citizens deriving income from China are not covered. This law implements a progressive rate, schedular tax system that will continue to exempt the majority of Chinese citizens from personal income tax.

Angel Q. Yoingco:

PHILIPPINES: EXPERIENCE WITH TAX AMNESTY LEGISLATION 172

With tax amnesty legislation being considered in many nations as a means of bringing past evaders back into the fold, the lessons to be learned from the experience of the Philippines can be important. The author reviews the series of Executive Orders granting amnesty to tax evaders beginning with the Marcos regime and concluding with the first, and supposedly only, amnesty to be granted by the Aquino Government.

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Milan Bakeš:

CZECHOSLOVAKIA: CONVENTIONS ON THE AVOIDANCE OF DOUBLE TAXATION 181

Czechoslovakia has concluded several bilateral and two multilateral tax agreements. Mr. Bakeš reviews these various agreements and highlights the major differences in the bilateral agreements when compared with the OECD Model Convention. He also discusses the taxation of residents and non-residents in Czechoslovakia.

I.W. Harris:

HONG KONG: BUDGET 1987 186

Mr. Harris has provided a brief summary covering the major points of the recent Budget Speech of Mr. Piers Jacob, Financial Secretary, Hong Kong. This report lists the tax rate changes for personal income and corporate profits.

Fapiano Stowers:

WESTERN SAMOA: BUDGET 1987 187

The author provides a brief review of Western Samoan tax changes as revealed in the 1987 Budget Speech.

Erwin Spiro:

SOUTH AFRICA: THE 1987 MINI-BUDGET 188

Because of the elections to be held in the near future the Government only proposed minor changes. More significant changes are expected to be presented later in 1987.

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Barbade: Réforme de l'impôt sur le revenu: analyse des deux budgets de 1986 151

L'année 1986 doit être marquée d'une croix dans l'histoire fiscale de la Barbade; il y a eu en effet deux séries de propositions budgétaires, en avril et en juillet. Le budget de juillet proposait un ensemble de réductions fiscales, inconnues dans l'histoire fiscale d'après-guerre de la Barbade. Cette étude analyse ces deux budgets en faisant ressortir les conséquences macro-économiques; si les réductions d'impôt sur le revenu des personnes physiques peuvent stimuler d'une certaine façon l'économie, elles ne peuvent certainement pas promouvoir la production pour l'exportation.

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Michael Howard:

Barbados: Die Einkommensteuerreform – Eine Analyse der beiden Haushalte des Jahres 1986 151

Das Jahr 1986 stellt einen wichtigen Meilenstein in der fiskalen Geschichte von Barbados dar. In diesem Jahr gab es zwei Haushaltsentwürfe, und zwar im April und Juli. Der Haushalt im Juli sah eine umfangreiche Zahl an Steuersenkungsmassnahmen vor, die in der Nachkriegsgeschichte von Barbados keine Parallele hat. Dieser Artikel untersucht die makro-ökonomischen Auswirkungen der beiden Haushalte. Dabei wird aufgezeigt, dass eine Senkung der persönlichen Einkommensteuer zwar einen leicht stimulierenden Effekt auf die Wirtschaft haben kann, dass dies aber nicht die Produktion für den Export zu fördern vermag.

Sylvain R.F. Plasschaert:

Die Schwächen der dualistischen (kombinierten) Methoden der Einkommensbesteuerung 161

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L'auteur analyse les différents types de systèmes fiscaux dualistes pour lesquels certaines catégories de revenus soumis à une imposition cédulaire sont par ailleurs assujettis à une imposition additionnelle sur l'ensemble des revenus. Bien que ce système ait été appliqué autrefois dans un certain nombre de pays (par exemple en France), et continue de l'être dans certains pays en voie de développement, il ne repose pas sur une analyse théorique convaincante. On considère souvent que dans un système fiscal dualiste, les avantages que présente un système fiscal cédulaire et global s'annulent lorsqu'ils sont combinés. L'auteur est prêt à accepter un système dualiste, par exemple dans une période transitoire, lors du passage d'un système fiscal cédulaire à un système global.

Li Jinyan:

République Populaire de Chine: Le nouvel impôt régulateur sur le revenu des personnes physiques *167*
Mme Li traduit et commente le texte du nouvel impôt régulateur sur le revenu qui vient d'être introduit en Chine et est entré en vigueur le 1er janvier 1987. Ce nouvel impôt ne s'applique qu'aux ressortissants chinois résidents: les étrangers et ressortissants chinois non-résidents percevant des revenus en provenance de la Chine ne sont pas visés par la loi. Cette loi prévoit qu'un tarif progressif s'appliquera dans le système fiscal cédulaire tout en continuant d'exempter la majorité des ressortissants chinois de l'impôt sur le revenu des personnes physiques.

Angel Q. Yoingco:

Philippines: Expérience de législation sur l'amnistie fiscale *172*
Les leçons tirées de l'expérience des Philippines quant à l'amnistie fiscale pourraient être fructueuses pour beaucoup de pays qui souhaiteraient que les "fraudeurs" rentrent au bercail. L'auteur analyse les différents règlements qui ont garanti l'amnistie aux fraudeurs fiscaux en commençant par ceux pris au cours du régime de Marcos et en terminant par la première, et probablement la seule , amnistie qui sera accordée par le gouvernement Aquino.

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Milan Bakeš:

Tchécoslovaquie: Conventions destinées à éviter les doubles impositions *181*
La Tchécoslovaquie a signé plusieurs conventions fiscales bilatérales et deux multilatérales. M. Bakeš passe en revue ces différentes conventions et fait ressortir les principales différences existant entre celles-ci et la Convention modèle de l'OCDE. Il analyse également l'imposition en Tchécoslovaquie des résidents et des non-résidents.

I.W. Harris:

Hong-Kong: Budget 1987 ..... *186*
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Fapiano Stowers:

Samoa occidental: Budget 1987 ..... *187*
L'auteur donne un bref aperçu des modifications fiscales de Samoa occidental telles qu'elles ont été mentionnées dans la présentation du budget pour 1987.

Erwin Spiro:

Le mini-budget 1987 de la République sud-africaine *188*
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Der Verfasser erläutert die verschiedenen Formen dualistischer Steuersysteme, wobei die Besteuerung einiger Einkunftsarten durch zeduläre Steuern mittels einer globalen Zusatzsteuer auf das Gesamteinkommen ergänzt wird. Obwohl ein derartiges System in der Vergangenheit in einer Reihe von Ländern angewandt wurde (z.B. in Frankreich), und in verschiedenen Entwicklungsländern noch stets angewandt wird, basiert seine theoretische Grundlage nicht auf einer fundierten Analyse. Es wurde oft behauptet, dass ein dualistisches Steuersystem die Vor- und Nachteile des zedulären und globalen Steuersystems ausbalanciert. Der Verfasser ist bereit, die Anwendung eines dualistischen Steuersystems in Ausnahmefällen gutzuheissen, beispielsweise dann, wenn dies in einer Übergangsphase zwischen der Anwendung des zedulären und des globalen Steuersystems geschieht.

Li Jinyan:

Volksrepublik China: Die neue "Regulierungs-Einkommensteuer" *167*
Frau Li legt eine Übersetzung des Gesetzestextes der neuen chinesischen "Regulierungs-Einkommensteuer", die am 1. Januar 1987 in Kraft getreten ist, vor und kommentiert die verschiedenen Bestimmungen. Diese neue Steuer betrifft lediglich chinesische Staatsbürger, die in China ansässig sind; Ausländer und nichtansässige chinesische Staatsbürger, die Einkünfte in China erzielen, sind hiervon nicht betroffen. Dieses Gesetz sieht progressive Steuersätze innerhalb eines zedulären Systems vor, das aber weiterhin die grosse Mehrheit der chinesischen Bürger von der Besteuerung ausnehmen wird.

Angel Q. Yoingco:

Die philippinischen Erfahrungen mit der Steueramnestie-Gesetzgebung *172*
Mit Steueramnestie-Gesetzgebungsplänen beschäftigen sich derzeit viele Länder, um eine Rückführung der Gelder anzustreben, die in der Vergangenheit illegal transferiert worden waren; dabei können die Erfahrungen, die man in den Philippinen gemacht hat, sehr wichtig sein. Der Verfasser vermittelt einen Überblick über die Executive Orders zu den Steueramnestien, wie sie früher vom Marcos-Regime gewährt wurden, und über die – vermutlich einmalige – Steueramnestie, wie sie die Aquino-Regierung anbietet.

IFA Mitteilungen *180*

Milan Bakeš:

Die Doppelbesteuerungsabkommen der Tschechoslowakei *181*
Die Tschechoslowakei hat einige bilaterale und zwei multilaterale Abkommen zur Vermeidung der Doppelbesteuerung abgeschlossen. Herr Bakeš erläutert diese Abkommen und zeigt die wesentlichen Unterschiede der bilateralen Abkommen im Vergleich zum OECD-Musterabkommen auf. Ferner bespricht er die Besteuerung ansässiger und nichtansässiger Personen in der Tschechoslowakei.

I.W. Harris:

Hong Kong: Der Haushalt 1987 ..... *186*
Herr Harris präsentiert eine kurze Zusammenfassung der wichtigsten Punkte der kürzlich von Herrn Piers Jacob, Hong Kongs Financial Secretary, gehaltenen Haushaltsrede. Dieser Bericht beinhaltet die Änderungen in den Steuersätzen sowohl für das Einkommen der natürlichen Personen als auch der Körperschaften.

Fapiano Stowers:

Western Samoa: Der Haushalt 1987 ..... *187*
Der Verfasser vermittelt einen Überblick über die Änderungen des Steuerrechts, die mit der Verlesung der Haushaltsrede mitgeteilt wurden.

Erwin Spiro:

Südafrikas Haushalt für 1987 ..... *188*
Wegen der in Kürze abzuhaltenden Wahlen schlägt die Regierung nur unbedeutende Änderungen vor. Es wird damit gerechnet, dass im späteren Verlauf des Jahres 1987 weitreichende Änderungen vorgeschlagen werden.

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CANADA: INTERNATIONAL TRANSFER PRICING AND OTHER INTERNATIONAL TRANSACTIONS (INFORMATION CIRCULAR) 199

On 27 February 1987 Revenue Canada released an Information Circular on international transfer pricing and other international transactions. This circular explains the basis on which the Taxation Department considers that the "arm's length principle" is reflected in the Income Tax Act.

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Frederic E. White:

U.S.A.: TAXATION OF FOREIGN CURRENCY TRANSACTIONS UNDER THE TAX REFORM ACT OF 1986 206

The author provides a historical perspective to the development of foreign currency taxation. Thereafter, he explains the overall effects of the new legislation and the accounting impact. This is done by means of definitions and exhibits as Mr. White moves the reader from the methodology to the application of the rules.

PEOPLE'S REPUBLIC OF CHINA: THE EMERGENCE OF LOCAL INVESTMENT REGULATIONS 215

A brief compilation of local provisions recently enacted in the People's Republic of China.

Kailash C. Khanna:

INDIA: BUDGET 1987-88 216

The author states his position concerning the 1987-88 Budget proposed by the Prime Minister, Mr. Rajiv Gandhi. After reviewing the growth in the deficit as well as military defence expenditures, Mr. Khanna discusses the proposals for growth. His conclusion reveals little support for Mr. Gandhi and indicates that the Budget plans for 1987-88 will be ineffective.

Nandita Sen:

INDIA: LOSSES MAY BE SET OFF AGAINST FOREIGN-SOURCE DIVIDENDS EXEMPT UNDER A TAX TREATY 221

Mrs. Sen reviews a recent decision by the Supreme Court of India, CIT v. Mahalaxmi Sugar Mills Ltd. (1986), 160 ITR 920 (S.C.). This case is important as it reasserts the authority of a nation to determine assessable income under domestic law. The Treaty for the Avoidance of Double Taxation is invoked after the determination of tax liability under the domestic law. The author closes by positing a few issues that the Supreme Court failed to address.

Torao Aoki:

JAPAN: ONGOING TAX REFORM II 224

This is the second part in a series of articles provided by Professor Aoki concerning the work of the Tax Commission to create and draft proposals for the modernization of the outdated Japanese tax system.

Lee Fook Hong:

SINGAPORE: A SUMMARY OF THE 1987 BUDGET'S TAX CLAUSES 232

The author provides a concise overview of the major tax provision changes presented in the 1987 Budget Speech of Dr. Richared Hu, Minister of Finance. Attached are lists of the new duty rates for tobacco, cigarettes and liquor.

James Leavy:

COLOMBIA: TAX REFORM CHANGES TO EXISTING RULES 235

The author up-dates his information provided in the January 1987 issue of the Bulletin regarding tax exemptions for repatriated profits of foreign petroleum companies. He also discusses other changes in the Colombian tax laws enacted since the passage of the tax reform.

Máximo Bomchil (Jr.):

ARGENTINA: TAXATION OF ROYALTIES 236

The determination of source and the taxation of services, royalties, and other intangibles is alway a problem. The author reviews the law of Argentina and attempts to explain the sourcing rules. Thereafter, he provides a brief overview of the royalties clause contained in the double taxation agreements concluded by Argentina indicating various points of contention. Mr. Bomchil concludes with a question relevant to every nation: what is the status of a treaty as compared to domestic law?

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Canada: La détermination du prix de transfert international et autres transactions internationales (Circulaire d'informations) *199*

Le Fisc canadien a distribué le 27 février 1987 une circulaire d'informations sur le prix de transfert international et autres transactions internationales. Cette circulaire analyse comment, selon la Division fiscale, le principe de l'assimilation à une enterprise indépendante se reflète dans la loi sur l'impôt sur le revenu.

Carnet des Congrès *205*

Frederic E. White:

Etats-Unis: Imposition des transactions de devises en application de la loi de 1986 sur la réforme fiscale *206*

L'auteur donne une analyse historique de l'évolution de l'imposition des devises. Il explique ensuite les effets globaux de la nouvelle lé-

INHALTSVERZEICHNIS

Kanada: Regelung bezüglich der internationalen Verrechnungspreise und sonstiger internationaler Vorgänge (Information Circular) *199*

Am 27. Februar 1987 veröffentlichte die kanadische Steuerbehörde ein Informations-Rundschreiben zu den internationalen Verrechnungspreisen und sonstigen internationalen Vorgängen. Das Rundschreiben erläutert die Verwendung des "dealing-at-arm's length" – Prinzips bei der Anwendung der Bestimmungen des Einkommensteuergesetzes durch die Steuerverwaltung.

Veranstaltungskalender *205*

Frederic E. White:

USA: Die Besteuerung der Devisentransaktionen nach dem Steuerreformgesetz von 1986 ..... *206*

Der Verfasser vermittelt eine historische Perspektive bezüglich der Besteuerung der Devisentransaktionen. Danach erklärt er die Ge-

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gislation et son impact comptable en donnant des définitions et des exemples; par cette méthode M. White passe de la méthodologie à l'application des règles.

République Populaire de Chine: Publication d'un certain nombre de réglementations locales d'investissements 215
Compilation rapide de dispositions locales publiées récemment en République Populaire de Chine.

Kailash C. Khanna:

Inde: Le budget 1987-88 216
L'auteur donne son avis quant au budget 1987-88 proposé par le Premier Ministre, M. Rajiv Gandhi. Après avoir considéré la croissance du déficit et les dépenses militaires, Mr. Khanna commente les propositions de croissance. Il ressort de ses conclusions peu de support pour M. Gandhi; les plans pour 1987-88 seront, selon lui, inefficaces.

Nandita Sen:

Inde: Les pertes peuvent être compensées par des dividendes de source étrangère exemptés en application d'un traité 221
Madame Sen analyse une décision récente de la Cour Suprême de l'Inde CIT contre Mahalaxmi Sugar Mills Ltd (1986), 160 ITR 920 (S.C.). Cet arrêt est important dans la mesure où il réaffirme l'autorité d'une nation à déterminer le revenu imposable suivant sa loi nationale. Ce n'est qu'après la détermination de l'imposition suivant la loi nationale qu'une convention de double imposition peut être invoquée. L'auteur termine en mentionnant quelques conclusions omises par la Cour.

Torao Aoki:

Japon: Réforme fiscale en cours II 224
Seconde partie d'une série d'articles, rédigés par le Professeur Aoki, portant sur le travail réalisé par la Commission fiscale aux fins de proposer des projets de modernisation du système fiscal japonais désuet.

Lee Fook Hong:

Singapour: Résumé des dispositions fiscales du budget 1987 232
L'auteur fait un résumé des principales modifications fiscales contenues dans la présentation du budget du Dr. Richard Hu, Ministre des Finances. Une liste des nouveaux taux applicables aux tabac, cigarettes et liqueurs est annexée au résumé.

James Leavy:

Colombie: Modifications fiscales aux règles existantes 235
L'auteur met à jour ses informations contenues dans le numéro de janvier 1987 du Bulletin portant sur les exemptions fiscales applicables aux bénéfices rapatriés des sociétés pétrolières étrangères. Il commente également les autres modifications aux lois fiscales colombiennes entrées en vigueur depuis l'introduction de la réforme fiscale.

Máximo Bomchil (jr.):

Argentine: Imposition des redevances 236
La détermination de la source et l'imposition des services, redevances et autres éléments immatériels pose toujours des problèmes. L'auteur analyse la législation sur ce point en Argentine et essai d'en expliquer les règles. Il donne également un bref aperçu de la clause sur les redevances contenue dans les conventions de double imposition signées par l'Argentine en mentionnant quelques points de contestations. M. Bomchil conclut en mentionnant un problème commun à tous les pays; quelle est la position d'un traité par rapport à la loi nationale?

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samtwirkungen der neuen Gesetzgebung und die Auswirkungen auf das Rechnungswesen. Dies wird durch entsprechende Definitionen bewerkstelligt, wobei Herr White den Leser von der Methodik zu der Anwendung der Bestimmungen führt.

Volksrepublik China: Die Publikation von Richtlinien der lokalen Behörden 215
Liste der Richtlinien der Provinze und sonstiger untergeordneter Gebietskörperschaften der Volksrepublik China, die in letzter Zeit veröffentlicht wurden.

Kailash C. Khanna:

Indien: Haushalt 1987-88 216
Der Autor nimmt zum Haushalt 1987-88 Stellung, der vom Ministerpräsidenten, Herrn Rajiv Gandhi, vorgelegt wurde. Nach den Ausführungen zum Anwachsen des Haushaltsdefizits und der Verteidigungsausgaben untersucht Herr Khanna die allgemeinen wirtschaftlichen Wachstumsaussichten. Seine Schlussfolgerung besteht darin, dass der Haushaltplan 1987-88 keine Effekte haben wird, und sie lässt auf wenig Unterstützung für Herrn Gandhi schliessen.

Nandita Sen:

Indien: Die Verrechnung von Verlusten mit abkommensbefreiten Dividenden 221
Frau Sen vermittelt einen Überblick über die Entscheidung im Fall CIT gegen Mahalaxmi Sugar Mills Ltd. (1986), 160 ITR 920 (S.C.) des höchsten Gerichtshofs von Indien. Dieser Fall ist deshalb bedeutend, weil er das Recht eines Landes betont, der Besteuerung unterliegende Einkünfte nach den Regeln des nationalen Rechts zu erfassen. Das Doppelbesteuerungsabkommen kommt zur Anwendung, nachdem die Bestimmung der Steuerpflicht nach nationalem Recht stattgefunden hat. Die Verfasserin schliesst ihren Überblick damit ab, dass Sie einige Problemkreise beleuchtet, die der Gerichtshof ausser Betracht liess.

Torao Aoki:

Japan: Die fortschreitende Steuerreform II 224
Dieses ist der zweite Teil einer Artikelserie, in der Prof. Aoki die Arbeit der Steuerkommission vorstellt, die daraufhin ausgerichtet ist, Vorschläge für eine Modernisierung des altmodischen japanischen Steuersystems zu machen.

Lee Fook Hong:

Singapur: Eine Zusammenfassung der steuerlichen Änderungsvorschriften im 1987-Haushalt 232
Der Verfasser vermittelt einen kurzen Überblick über die wichtigsten steuerlichen Änderungsvorschriften, die der Finanzminister, Herr Dr. Richard Hu, in seiner Haushaltsrede angekündigt hat. Eine Liste mit den neuen Steuersätzen für Tabak, Zigaretten und Getränke ist angeschlossen.

James Leavy:

Kolumbien: Die Steuerrechtsänderungen aufgrund der Steuerreform 235
Der Verfasser bringt die Informationen auf den neuesten Stand, die er in seinem Artikel in der Januar-Ausgabe des Bulletin gegeben hat und die eine Steuerbefreiung für Gewinnüberweisungen ausländischer Ölgesellschaften vorsah. Er bespricht auch die sonstigen Änderungen im kolumbianischen Steuerrecht, die mit dem Inkrafttreten der Steuerreform wirksam wurden.

Máximo Bomchil jun.:

Die Besteuerung der Lizenzgebühren in Argentinien 236
Die Bestimmung der Quelle und die Einkommensbesteuerung von Dienstleistungen, Lizenzgebühren und anderen Immaterialgütern stellt stets ein Problem dar. Der Verfasser untersucht die Bestimmungen des argentinischen Steuerrechts und unternimmt den Versuch, die Regeln der Quellenbestimmung zu erläutern. Danach vermittelt er einen Überblick über den Lizenzgebühren-Artikel in den Doppelbesteuerungsabkommen, die Argentinien abgeschlossen hat. Herr Bomchil schliesst seinen Beitrag mit der Frage ab, die jede Nation betrifft: die Stellung eines Doppelbesteuerungsabkommens im Verhältnis zum nationalen Recht?

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I.C.C. SYMPOSIUM ON CONSEQUENCES FOR INTERNATIONAL BUSINESS OF THE U.S. TAX REFORM 251

The U.S. Tax Reform Act of 1986 has resulted in many changes in the handling of corporate business. The natural consequences of such a major alteration in the U.S. tax system have been felt throughout the world. In response to this perceived impact the I.C.C. has organized a symposium. The Bureau has reprinted three of the papers presented at this symposium and a conclusion written by the staff of the I.C.C.

- **G.D. Swaine: Impact on the Tax Policies of the United Kingdom** ... 251
- **Dr. K.D. Wingert: Impact on the German Tax System** 256
- **Shigeru Nomura: Impact on the Japanese Tax System** 259

In each article the author discusses the manner in which his country of expertise is being affected and the various responses elicited.

A.D. Ross:

THE UNITED KINGDOM: LIVING WITH ANTI-TAX HAVEN LEGISLATION: THREE YEARS OF U.K. EXPERIENCE ... 263

The author reviews the Controlled Foreign Company (CFC) legislation of the United Kingdom, discussing its effects 3 years after implementation. After first outlining its common features with regard to similar legislation by other nations, he distinguishes the U.K. law and explains the various exemption tests. Mr. Ross closes by indicating a few tax planning possibilities.

Dr. J.M. Elegido:

NIGERIA: TAXATION OF DIVIDENDS 271

The author provides a review of the legislation presently effective in Nigeria concerning dividends and their application. The major point is the tax-free dividend period announced by the Government of 3 years for all qualifying companies and 5 years for a specified group. The oil industry is included in this group of industries receiving extra benefits.

M.M. Sury:

INDIA: DECLINE OF DIRECT TAXES 279

The author documents the declining role of direct taxes in India. His position is that the increasing use of indirect taxes results in regressivity in the tax burden resulting in an unfair allocation of responsibility for revenue upon the poorer taxpayers. A reading may bring to light similar tendencies in other countries.

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H.K. Sondhi:

INDIA: INCOME TAX INCENTIVES – HARNESSING CORPORATE SKILLS FOR RURAL DEVELOPMENT 283

With a high percentage of the population deriving its income from labour in rural areas, India must develop a coherent system of taxation with the social goal of developing these regions. The author reviews the various plans implemented to date in an effort to support and encourage rural development.

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Symposium I.C.C. sur les conséquences de la réforme fiscale américaine dans le monde des affaires internationales 251

La loi de 1986 sur la réforme fiscale américaine a entraîné de nombreuses modifications dans les tractations commerciales. Les conséquences logiques d'une modification de première importance du système fiscal américain ont été ressenties dans le monde entier. L'impact de cette modification a conduit l'I.C.C. à organiser un symposium sur ce sujet. Le Bureau publie ici trois des études présentées à ce symposium ainsi que la conclusion rédigée par l'équipe de l'I.C.C.

- *G.D. Swaine: Impact sur les politiques fiscales du Royaume-Uni* 251
- *Dr. K.D. Wingert: Impact sur le système fiscal allemand* 256
- *Shigeru Nomura: Impact sur le système fiscal japonais* 259

L'auteur de chaque article indique de quelle façon son pays a été affecté par la réforme et commente les solutions qui en ont découlées.

INHALTSVERZEICHNIS

Das Symposium der Internationalen Handelskammer zu den Auswirkungen der amerikanischen Steuerreform auf internationale Unternehmen 251

Das amerikanische Steuerreform-Gesetz von 1986 hat eine Vielzahl von Änderungen bezüglich der Behandlung von Körperschaften zur Folge. Die sich aus einer solchen wichtigen Änderung im US-Steuersystem ergebenden Konsequenzen sind weltweit zu verzeichnen. Um auf diese Auswirkungen eine Antwort geben zu können, organisierte die Internationale Handelskammer ein Symposium. Das Internationale Steuerdokumentationsbüro druckt drei Manuskripte von Vorträgen ab, die bei diesem Symposium gehalten wurden; ferner werden die Schlussfolgerungen reproduziert, die von Mitarbeitern der Internationalen Handelskammer gezogen wurden.

- *G.D. Swaine: Die Auswirkungen auf die Steuerpolitik in Grossbritannien* 251
- *Dr. K.D. Wingert: Die Auswirkungen auf das Steuersystem der Bundesrepublik Deutschland* 256
- *Shigeru Nomura: Die Auswirkungen auf das japanische Steuersystem* ... 259

In jedem dieser Artikel wird von den Autoren dargelegt, welche Auswirkungen die US-Steuerreform im entsprechenden Land hat und wie die jeweilige Antwort aussieht, die darauf gegeben wird.

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A.D. Ross:

Royaume-Uni: Vivre avec la législation anti-refuge fiscal: 3 années d'expérience britannique 263
L'auteur analyse la législation sur "Controlled Foreign Company" du Royaume-Uni tout en commentant ses effets 3 ans après son introduction. Après avoir indiqué ses points communs avec des législations similaires applicables dans d'autres pays, il fait remarquer les particularités de la loi britannique et analyse les différents critères d'exemption. M. Ross termine en indiquant quelques possibilités de gestion fiscale.

Dr. J.M. Elegido:

Nigeria: Imposition des dividendes 271
L'auteur présente la législation sur les dividendes et leurs applications actuellement en vigueur au Nigéria. Le point le plus important est la période de 3 ans d'exemption d'impôt sur les dividendes annoncée par le gouvernement en faveur de toutes les sociétés "qualifiées" et de 5 ans en faveur d'un groupe spécifié par la loi. L'industrie pétrolière fait partie de ce groupe d'industries bénéficiant d'un régime plus favorisé.

M.M. Sury:

Inde: Déclin des impôts directs 279
L'auteur mentionne le déclin du rôle joué par les impôts directs en Inde. Il considère que le recours croissant aux impôts indirects a pour conséquence une diminution de la pression fiscale, faisant ainsi dépende de façon injuste une grande part des recettes fiscales des contribuables les plus pauvres. La lecture de cet article pourrait révéler des tendances similaires existant dans d'autres pays.

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H.K. Sondhi:

Inde: Avantages fiscaux sur le revenu – Mise en place de sociétés en faveur du développement rural 283
En raison de l'importance de la population tirant son revenu d'un travail exercé dans des zones rurales, l'Inde doit développer un système cohérent d'imposition se donnant pour but social le développement de ces régions. L'auteur mentionne les différents projets mis en oeuvre tendant à supporter et encourager le développement rural.

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A.D. Ross:

Grossbritannien: Leben mit der Anti-Steueroasen-Gesetzgebung: Drei Jahre Erfahrung in Grossbritannien 263
Der Verfasser untersucht die "Controlled Foreign Company" (beherrschte Auslandsgesellschaften) – Gesetzgebung in Grossbritannien vor dem Hintergrund der in den drei Jahren nach deren Einführung gemachten Erfahrungen. Nachdem zuerst gemeinsame Merkmale dieser Bestimmungen mit ähnlichen Vorschriften anderer Länder verglichen werden, konzentriert sich der Verfasser auf das britische Recht und erläutert die diversen Ausnahmen. Herr Ross rundet seinen Beitrag mit dem Aufzeigen einiger Steuerplanungsmöglichkeiten ab.

Dr. J.M. Elegido:

Nigeria: Die Besteuerung der Dividenden 271
Der Verfasser vermittelt einen Überblick über die derzeit in Nigeria gültige Gesetzgebung bezüglich der Besteuerung der Dividenden. Der wichtigste Punkt betrifft die von der Regierung angekündigte Steuerbefreiung für Dividenden, die von allen entsprechend berechtigten Gesellschaften an die Anteilseigner während der ersten 3 Jahre gezahlt werden; für eine bestimmte Gruppe beträgt die Steuerbefreiungsperiode 5 Jahre. Die Ölindustrie ist in die Gruppe der Industrien einbezogen, die diese speziellen Vorteile in Anspruch nehmen kann.

M.M. Sury:

Indien: Rückgang der Bedeutung der direkten Steuern 279
Der Verfasser belegt die abnehmende Bedeutung der direkten Steuern in Indien. Sein Standpunkt ist der, dass die zunehmende Anwendung von indirekten Steuern eine regressive Wirkung bezüglich der Steuerbelastung hat, was zu einem ungerechtfertigt hohen Anteil der ärmeren Steuerpflichtigen am Steueraufkommen führt. Das Studium dieses Artikels könnte die Existenz ähnlicher Tendenzen in anderen Ländern ans Licht bringen.

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H.K. Sondhi:

Indien: Einkommensteuervergünstigungen – Der gezielte Einsatz des Unternehmenssektors in die ländliche Entwicklung 283
Ein grosser Teil der Bevölkerung Indiens erzielt sein Arbeitseinkommen in ländlichen Gebieten. Um diesen Gebieten eine angemessene Entwicklung zu gewährleisten, muss Indien ein logisch aufgebautes Steuersystem einführen. Der Verfasser analysiert die verschiedenen Pläne, die bis zum heutigen Tag im Blick auf die Förderung der ländlichen Entwicklung implementiert wurden.

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The First East-West Tax Conference

On 14 and 15 April 1987 the International Bureau of Fiscal Documentation organized its first East-West Tax Conference in Salzburg (Austria). Tax experts from both Eastern and Western European countries gave their views on recent and future tax developments in Eastern Europe and the importance thereof for Western companies doing business in those countries. This issue of the *Bulletin* publishes the papers submitted by: Prof. Dr. Dennis Campbell (joint ventures between East and West); Dr. Herwig E. Haase (direct taxes in East and West); Mr. Dick Hund (tax treatment of Eastern European source income in the Netherlands); and Dr. W. Albeseder (tax treatment of Eastern European source income in Austria). In addition, this issue contains articles by Prof. Dr. Knauthe and Prof. Dr. Hans Spiller on obligatory payments in the German Democratic Republic and by Dr. Ioan Condor on joint ventures in Romania.

The October issue of the *Bulletin* will publish the other papers submitted at the First East-West Tax Conference by local tax experts on tax developments in Hungary, Yugoslavia and the Soviet Union. Papers by tax experts from the Federal Republic of Germany and Italy discussing the significance of Eastern European developments for companies in their countries, as well as a paper discussing specific aspects of East-West tax treaties, will complete this issue.

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Prof. Dr. Dennis Campbell:

JOINT VENTURES BETWEEN EAST AND WEST 299

Prof. Dr. Campbell points out the reasons for the recent growth of legislated opportunities for joint-venture activity between Eastern European countries and Western enterprises. He then discusses the general similarities between the laws of the various States and concludes that we may hope that the business exchanges will provide some political stability in contrast to our historical experiences.

Dr. Herwig E. Haase:

DIRECT TAXES IN EAST AND WEST 304

Dr. Haase indicates how the theory of tax is joined to economics. He proceeds to analyze empirically the effects of taxation. The author concludes by calling for the development of an international, comparative theory of public finance whereby theoretical fundamentals, concepts and statistical evidence will be in a standardized form.

D. Hund:

THE NETHERLANDS: TAXATION OF EASTERN EUROPEAN SOURCE INCOME 319

The author establishes the framework within which income from Eastern European sources is taxed by describing the Dutch tax system, including some of its peculiarities and unique advantages. Thereafter he discusses the various treaties the Netherlands has concluded in recent years and closes by providing insightful discussions of some recent Dutch court decisions.

Dr. Werner Albeseder:

AUSTRIA: TAXATION OF EASTERN EUROPEAN SOURCE INCOME 326

The author reviews the longstanding relationship between Eastern Europe and Austria and indicates the various advantages under treaties and domestic law available for the foreign investor. Dr. Albeseder comments briefly on Austrian exchange control regulations and the Cyprus route.

Erhardt Knauthe and Hans Spiller:

GERMAN DEMOCRATIC REPUBLIC: THE STRUCTURE OF OBLIGATORY PAYMENTS TO THE NATIONAL BUDGET AND THE MANAGEMENT OF THE SOCIALIST ECONOMY 329

The authors discuss the manner in which obligatory payments are being used to pursue specific goals of the German Democratic Republic's Government in such areas as the consumption of scarce resources, e.g. labour, land and energy. The paper exhibits how compulsory transfers of funds to the State are intended to increase production efficiency and redistribute income.

Ioan Condor:

ROMANIA: TAXATION OF JOINT VENTURES AND NON-RESIDENTS 337

This article provides a review of the historical development of joint-venture laws as well as the taxation of various non-resident entities under Romanian fiscal legislation. Thereafter, the author sets forth the method for calculating the tax on joint ventures.

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Prof. Dr. Dennis Campbell:

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Prof. Campbell zeigt die Gründe auf, die dazu geführt haben, dass in der jüngsten Zeit gesetzliche Grundlagen für die Aktivitäten von Gemeinschaftsunternehmen zwischen osteuropäischen Ländern und westlichen Unternehmen geschaffen wurden. Danach vergleicht er die Bestimmungen in den Gesetzen der verschiedenen Länder, die sich ähnlich sind, um schliesslich seiner Hoffnung Ausdruck zu verleihen, dass die unternehmerische Zusammenarbeit eine politische Stabilität bewerkstelligen kann, die im Gegensatz zu den historischen Erfahrungen steht.

Dr. Herwig E. Haase:

Die direkten Steuern in Ost und West 304
Dr. Haase zeigt die Verbindung zwischen der Steuertheorie und der Wirtschaft durch eine empirische Analyse der Besteuerungseffekte auf. Er schliesst seinen Beitrag damit ab, dass er für die Entwicklung einer international vergleichbaren Theorie der öffentlichen Finanzwirtschaft plädiert, wobei diese auf standartisierten theoretischen Konzepten und statistischen Grundlagen basieren sollte.

D. Hund:

Niederlande: Die Besteuerung der Einkünfte aus osteuropäischer Quelle 319
Der Verfasser stellt den Rahmen dar, innerhalb dessen die Einkünfte aus osteuropäischer Quelle im niederländischen Steuerrecht zu behandeln sind, wobei er insbesondere auf einige Besonderheiten und Vorteile hinweist. Danach bespricht er die verschiedenen Doppelbesteuerungsabkommen, die die Niederlande in den letzten Jahren abgeschlossen haben. Der Artikel wird durch die Erläuterung einiger kürzlich ergangener Gerichtsentscheidungen abgerundet.

Dr. Werner Albeseder:

Österreich: Die Besteuerung der Einkünfte aus osteuropäischer Quelle 326
Der Verfasser beleuchtet zunächst die historischen Verbindungen zwischen Osteuropa und Österreich und zeigt die verschiedenen Vorteile auf, die dem in Österreich tätig werdenden ausländischen Investor sowohl nach den Doppelbesteuerungsabkommen als auch nach dem nationalen Recht offenstehen. Dr. Albeseder geht auch kurz auf die österreichischen Devisenvorschriften und auf die "Zypern-Route" ein.

Erhardt Knauthe und Hans Spiller:

Die Pflichtabführungen an den Staatshaushalt und die Leitung der sozialistischen Wirtschaft in der DDR – Die Rolle der Resourcenabgaben – 329
Die Verfasser untersuchen die Art und Weise, in der Pflichtabführungen dazu genutzt werden, die spezifischen Ziele der Regierung der DDR auf dem Gebiet des Konsums knapper Resourcen wie z.B. Arbeit, Land und Energie zu erreichen. Dieser Artikel stellt dar, wie die Pflichtabführungen an den Staatshaushalt dafür verwendet werden, die Produktionseffizienz zu erhöhen und das Einkommen umzuverteilen.

Ioan Condor:

Rumänien: Die Besteuerung der Gemeinschaftsunternehmen und der Nichtansässigen 337
Dieser Artikel vermittelt einen Überblick über die historische Entwicklung der Gesetze zu den Gemeinschaftsunternehmen wie auch zur Besteuerung verschiedener nichtansässiger Personen im rumänischen Steuerrecht. Danach erläutert der Autor die Methode für die Berechnung der Steuer der Gemeinschaftsunternehmen.

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Professeur Dr. Dennis Campbell:

Sociétés en participation Est-Ouest 299
Le Professeur Campbell souligne les raisons de l'augmentation récente, en application de la loi, des possibilités d'activités offertes sous forme de sociétés en participation entre les pays de l'Europe de l'Est et les entreprises occidentales. Il analyse ensuite des points de ressemblances entre les lois des différents Etats et espère, en concluant, que les échanges commerciaux entraîneront une certaine stabilité politique, contrairement à nos expériences historiques.

Dr. Herwig E. Haase:

Impôts directs à l'Est et à l'Ouest 304
Le Dr. Haase indique dans quelle mesure la théorie de l'impôt est liée à l'économie. Il analyse d'une façon empirique les effets de l'imposition et conclut en se prononçant en faveur de la mise au point d'une théorie internationale et comparative des finances publiques où les fondements théoriques, les concepts et les statistiques seront présents sous une forme standardisée.

D. Hund:

Pays-Bas: Imposition des revenus ayant leur source dans l'Europe de l'Est 319
L'auteur détermine le cadre dans lequel un revenu ayant sa source dans l'Europe de l'Est est imposé en décrivant le système fiscal hollandais, y compris quelques-unes de ses particularités ainsi que ses avantages uniques. Il donne ensuite un commentaire des différents traités conclus par les Pays-Bas au cours de ces dernières années et termine en mentionnant les discussions perspicaces de quelques arrêts hollandais récents.

Dr. Werner Albeseder:

Autriche: Imposition des revenus ayant leur source dans l'Europe de l'Est 326
L'auteur analyse les relations déjà anciennes existant entre l'Europe de l'Est et l'Autriche et mentionne les différents avantages offerts aux investisseurs étrangers en application des traités et de la loi nationale. Le Dr. Albeseder commente rapidement les réglementations sur le contrôle des changes autrichien ainsi que "la route de Chypre".

Erhardt Knauthe et Hans Spiller:

République Démocratique Allemande: La structure des paiements obligatoires en faveur du budget national et la gestion du budget socialiste 329
Les auteurs commentent la façon dont les paiements obligatoires sont utilisés pour la poursuite de buts particuliers du gouvernement de la République Démocratique Allemande dans des domaines tels que celui de la consommation de ressources peu abondantes, comme la main-d'oeuvre, les terres et l'énergie. L'article démontre comment les transferts de fonds obligatoires en faveur de l'Etat ont pour but d'augmenter l'efficacité de la production et de redistribuer le revenu.

Ioan Condor:

Roumanie: Imposition des sociétés en participation et des non-résidents 337
Cet article donne un aperçu de l'historique de la législation sur les sociétés en participation ainsi que de l'imposition de différentes entités non-résidentes selon le droit fiscal roumain. L'auteur mentionne, en terminant, la méthode de calcul de l'impôt sur les sociétés en participation.

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Richard M. Hammer:

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Mark Eyskens, Belgian Minister of Finance:

TAXATION IN BELGIUM – RECENT MEASURES AND FUTURE PROSPECTS 356

Since the beginning of the 80's the policy of the Belgian Government has been to get the Belgian economy in line with the economies of its principal trading partners. Within the medium term strategy, fiscal policy has a major function and fiscal distortions have caused structural rigidities and have threatened Belgian competitiveness. The Belgian Government has taken action in lowering the rate of corporate income tax and introducing special schemes to stimulate investment, industrial adjustment and employment. A Royal Commission was formed to give its recommendation on tax reform. The Commission's report, which was completed in February, will be an important tool in drafting tax reform proposals.

Jean-Pierre Lagae:

BELGIUM: COORDINATION CENTERS 359

The author analyzes the legislation under which so-called coordination centers operate. The main advantage of such centers is that they permit the carrying on of administrative and other support services as well as a broad range of financial activities in an almost tax-free environment and outside the scope of exchange control regulations. A list supplementing the article shows that this legislation has attracted a large number of major multinational companies.

Charles Sibille and Michael D. Fryt:

BELGIUM: PLANNING FOR COORDINATION CENTERS AFTER U.S. TAX REFORM 371

The authors identify and explain the opportunity for U.S. based multinationals to use a Belgian coordination center to reduce their American tax burden. The article primarily focuses on the U.S. tax repercussions of establishing such a coordination center. A Belgian subsidiary may use Belgian coordination center legislation to reduce the effective foreign tax rate of a multinational group of companies. This will be a key consideration when dealing with the new U.S. "separate basket limitations" for foreign tax credit.

L.A. Denys:

THE PROPOSED BELGIAN TAX REFORM – ASPECTS OF INTERNATIONAL TAXATION 383

The author comments on the first Report of the Royal Commission for the Harmonization and Simplification of Taxation. Since a number of basic policy decisions in the reform have still to be taken by the Government and Parliament, the author's remarks focus on those options which may affect international taxation. These include the following issues concerning personal income tax: the structure and the rate; the taxation of certain kinds of earned income; business income; and, income from capital. With respect to corporate income tax he discusses the possible introduction of a full imputation system, the dividend exemption, tax incentives, group consolidations, liquidations and the treatment of foreign-source income. The article concludes with a discussion of indirect taxes and tax procedures.

H. Siebens:

BELGIUM: SOME SPECIAL ASPECTS OF FOREIGN SOURCE PROFITS AND LOSSES IN CORPORATE INCOME TAXATION 391

The author discusses a number of important problems connected with the relationship between a Belgian company and its permanent establishment located abroad. One group of problems concerns the determination of world-wide income of the Belgian company such as the treatment of foreign-source losses. A second group of problems is caused by the qualification of the permanent establishment as a separate taxpayer. Surprisingly, many of these problems have not yet been solved and in some cases the Belgian tax authorities have not expressed their opinion on this issue.

J. Malherbe:

SIMULATION, FRAUS LEGIS AND BUSINESS PURPOSE UNDER BELGIAN TAX LAW 396

The legal concept of "simulation" may be used by the Belgian tax authorities to attack certain transactions in which the primary purpose is to avoid tax. In contrast, the concepts of "fraus legis" and (genuine) "business purpose" have rarely – if ever – been applied by the Belgian courts to stop a taxpayer from minimizing his tax burden. It is the author's opinion that introducing such concepts may open the door to errors and arbitrariness and may thus create insecurity for taxpayers.

Luc Hinnekens:

BELGIUM: INTERNATIONAL ASPECTS OF TAXATION OF EXECUTIVE REMUNERATION 400

The tax burden in Belgium has during recent years increased to such an extent that Belgium currently ranks among the countries with the highest taxes in the world. The author shows, however, that executives resident in Belgium may substantially reduce their income tax liability under Belgian unilateral measures and tax treaty provisions. In certain cases routing of income via Cyprus is a good solution whereas to Belgian engineers and technicians stationed in non-European non-tax treaty countries a special favourable tax treatment is offered under an administrative circular letter. Foreign executives who are temporarily stationed in Belgium may also benefit from measures reducing their income tax liability under rulings which have been issued by the Belgian tax administration.

J.Autenne:

BELGIUM: TAX INCENTIVES FOR SCIENTIFIC RESEARCH ACTIVITIES 407

Belgium is well aware of the importance of research for the development of its economy and it has for that reason introduced specific tax incentives in addition to the aid it already gives through its national and regional agencies. The author describes the most important of these incentives taking into account that a taxpayer may opt between carrying on research activities in an existing organization or in a newly created company.

Jacoba Helfrich-Laubrock:

THE INTERNATIONAL CHAMBER OF COMMERCE (ICC): CRITICAL REVIEW OF THE OECD/COUNCIL OF EUROPE MULTILATERAL (DRAFT) CONVENTION ON MUTUAL ADMINISTRATIVE ASSISTANCE IN TAX MATTERS 410

The author sets forth the strong criticism of the ICC on the Draft Convention on Mutual Administrative Assistance in Tax Matters which was recently adopted by the OECD and the Council of Europe. She concludes that there is no need for such a far-reaching convention and she points out that international trade and investment will inevitably suffer from its application.

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Dr. Norbert Seeger:

TAX REFORM IN LIECHTENSTEIN 414

Liechtenstein has a system of general capital tax supplemented by a small income tax. Recently, after a review of the status of the

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population it was decided that income tax should become more dominant in its effect. The results of this change in attitude are discussed in this article by Dr. Seeger.

Har Govind:

INDIA: TAX TREATMENT OF PAYMENTS UNDER FOREIGN COLLABORATION AGREEMENTS 420
The steady growth of collaboration agreements has resulted in many disputes between the Indian Income-tax Department and the contracting parties. The terminology used in the agreement can have tax consequences. The author reviews the problems and the position of the courts with relation to collaboration agreements.

Lars-Erik Wenehed:

TAXES AND COMPUTERS 426
Mr. Wenehed provides an explanation of the computer system COMPTAX and, by means of a hypothetical, exhibits the COMPTAX programs' tax planning capabilities.

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Mark Eyskens, Ministre belge des Finances:

Imposition en Belgique: Dispositions récentes et perspectives d'avenir 356
Depuis le début des années 80, la politique du gouvernement belge s'est proposée d'essayer de placer l'économie belge au même niveau que celui de l'économie de ses principaux partenaires commerciaux. La politique fiscale a une fonction essentielle dans une stratégie à moyen terme, des distortions fiscales ont entraîné des intransigeances structurelles et menacé la compétitivité belge. Le gouvernement belge a décidé de baisser le taux de l'impôt sur le revenu des sociétés, d'introduire des schémas spéciaux pour stimuler les investissements, l'adaptation industrielle et l'emploi. Une Commission Royale a été spécialement créée pour donner ses recommandations sur la réforme fiscale. Le rapport de la Commission, achevé en février, sera un outil de travail important pour les projets de propositions de la réforme fiscale.

Jean-Pierre Lagae:

Belgique: Centres de coordination 359
L'auteur analyse la législation portant sur les centres de coordination. Ces centres sont intéressants dans la mesure où ils assurent les services administratifs, et autres services annexes, ainsi qu'un grand nombre d'activités financières sans qu'une charge fiscale y soit vraiment liée et en dehors du domaine des réglementations de contrôle de change. Cet article est accompagné d'une liste prouvant que cette législation a attiré un grand nombre d'importantes sociétés multinationales.

Charles Sibille et Michael D. Fryt:

Planning pour les centres de coordination belges après la réforme fiscale américaine 371
Les auteurs mentionnent et expliquent la possibilité offerte aux multinationales américaines d'utiliser un centre de coordination belge afin de réduire leur charge fiscale américaine. L'article insiste particulièrement sur les conséquences fiscales américaines lors de l'établissement d'un tel centre de coordination. Une filiale américaine peut utiliser la législation appliquée au centre de coordination afin de réduire le taux d'impôt étranger effectif d'un groupe de multinationales. C'est un point de considération qui sera déterminant lorsqu'on devra tenir compte des nouvelles "separate basket limitations" américaines pour le crédit d'impôt étranger.

L.A. Denys:

Proposition de réforme fiscale belge – Aspects de fiscalité internationale 383
L'auteur commente le Premier Rapport de la Commission Royale pour l'Harmonisation et la Simplification de la Fiscalité. Un certain nombre de décisions essentielles dans la réforme devant encore être prises par le Gouvernement et le Parlement, les remarques faites par l'auteur mettent l'accent sur les options pouvant avoir une influence sur la fiscalité internationale. Celles-ci comprennent des dispositions portant sur l'impôt sur le revenu des personnes physiques: la structure et le taux de l'impôt; l'imposition de certaines sortes de revenus provenant du travail, de revenus professionnels et de revenus tirés du capital. Il donne son avis quant à l'introduction possible d'un système d'imputation intégrale en matière d'impôt sur le revenu des sociétés, l'exemption des dividendes, les avantages fiscaux, les bénéfices consolidés pour les groupes, les liquidations et le traitement des revenus de source étrangère. L'article se termine par une discussion sur les impôts indirects et les procédures fiscales.

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Mark Eyskens, Finanzminister von Belgien:

Die Besteuerung in Belgien – Derzeitige Massnahmen und Zukunftsaussichten 356
Seit Anfang der achtziger Jahre war die Politik der belgischen Regierung daraufhin ausgerichtet, die belgische Wirtschaft auf die gleiche Linie wie die seiner wichtigsten Handelspartner zu bringen. Innerhalb einer mittelfristigen Strategie spielt die Fiskalpolitik eine wichtige Rolle, wobei festzuhalten ist, dass Verzerrungen auf diesem Gebiet strukturelle Ungleichgewichte verursachten, die die belgische Konkurrenzfähigkeit bedrohten. Die belgische Regierung veranlasste eine Reihe Massnahmen wie z.B. die Senkung des Körperschaftsteuersatzes und die Einführung bestimmter Vergünstigungen, wodurch die Investitionen, die Anpassung der Industrie und die Beschäftigung stimuliert wurden. Eine Königliche Kommission, die Vorschläge für eine Steuerreform machte, wurde gebildet. Der Bericht dieser Kommission, der im Februar vorgelegt wurde, wird eine wichtige Grundlage für die Formulierung der Steuerreformvorschläge sein.

Jean-Pierre Lagae:

Belgien: Die Koordinierungszentren 359
Der Verfasser analysiert die Gesetzgebung bezüglich der Funktionsweise der sog. Koordinierungszentren. Der hauptsächliche Vorteil dieser Zentren besteht darin, dass sie es möglich machen, eine Reihe von Verwaltungsaufgaben und andere unterstützende Dienstleistungen wie auch ein weites Feld von Finanzaktivitäten in einer fast steuerfreien Umgebung auszuüben unde darüberhinaus keinen Devisenvorschriften zu unterliegen. Eine dem Artikel angeschlossene Liste zeigt auf, dass man es verstand, durch diese Gesetzgebung eine beachtliche Zahl wichtiger multinationaler Gesellschaften anzulocken.

Charles Sibille und Michael D. Fryt:

Steuerplanung mittels belgischer Koordinierungszentren nach Inkrafttreten der U.S.-Steuerreform 371
Die Verfasser erläutern die Möglichkeiten, die sich in den U.S.A. ansässigen multinationalen Unternehmen bieten, durch die Einschaltung eines belgisches Koordinierungszentrums ihre amerikanische Steuerbelastung zu reduzieren. Diese Möglichkeit wird besonders in den Fällen eine Schlüsselrolle spielen, in denen es darum geht, die Fragen mit den speziellen Beschränkungen innerhalb der Einkunftsarten bei der Anrechnung ausländischer Steuern nach den neuen Vorschriften des U.S.-Steuerrechts zu lösen.

L.A. Denys:

Die geplante Steuerreform in Belgien – Die internationalen Aspekte 383
Der Verfasser nimmt zum ersten Bericht der Königlichen Kommission für die Harmonisierung und Vereinfachung der Besteuerung Stellung. Da noch eine Reihe von politischen Entscheidungen von grundsätzlicher Bedeutung von Regierung und Parlament getroffen werden müssen, konzentriert der Verfasser seine Bemerkungen auf die Gebiete, die die internationale Besteuerung beeinflussen könnten. Was die Einkommensteuer der natürlichen Personen betrifft, so erstreckten sich die Auswirkungen auf die Struktur der Steuersätze, auf die Besteuerung bestimmter Arbeitseinkünfte, auf gewerbliche Einkünfte und auf Kapitaleinkünfte. Bezüglich der Körperschaftsteuer erläutert er die Möglichkeit der Einführung eines Vollanrechnungssystems, die Dividendenfreistellung, steuerliche Förderungsmassnahmen, die Konsolidierung im Konzernverband, die Liquidationen

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The First East-West Tax Conference

On 14 and 15 April 1987 the International Bureau of Fiscal Documentation organized its first East-West Tax Conference in Salzburg (Austria). Tax experts from both Eastern and Western European countries gave their views on recent and future tax developments in Eastern Europe and the importance thereof for Western companies doing business in those countries. In the July issue of the *Bulletin* we published the papers submitted by: Prof. Dr. Dennis Campbell (Joint Ventures Between East and West); Dr. Herwig E. Haase (Direct Taxes in East and West); Mr. Dick Hund (Tax Treatment of Eastern European Source Income in the Netherlands); and Dr. W. Albeseder (Tax Treatment of Eastern European Source Income in Austria). In addition, that issue contained articles by Prof. Dr. Knauthe and Prof. Dr. Hans Spiller on obligatory payments in the German Democratic Republic and by Dr. Ioan Condor on joint ventures in Romania.

This issue of the *Bulletin* publishes the other papers submitted at the First East-West Tax Conference by: Mr. Willem Kuiper (East-West Tax Treaties); Prof. Dr. Tibor Nagy (Current Trends in Income Taxation in Eastern Europe); Mrs. L.W. Mamet (Tax Aspects of Joint Ventures in the U.S.S.R.); Prof. Dr. Jan Głuchowski (Tax Aspects of Joint Ventures in Poland); Mr. Miodrag Arsić (Taxation of Foreign Persons in Yugoslavia); Mr. Howard Liebman (Taxation of Eastern European Source Joint Venture Income in the U.S.) and Mr. József Lukács (VAT in Hungary).

It is with great pleasure that we publish these articles and we hope to be able to host a second conference in the near future which will provide papers of equal interest and quality.

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Prof. Dr. Tibor Nagy:

CURRENT TRENDS IN INCOME TAXATION IN EASTERN EUROPE 439

In recent years the Eastern European countries have been modifying, altering and reforming their tax systems. The author explains the foundation of these changes and the relationship of the new tax systems to the old by noting the development of the Soviet Union's tax system and the Hungarian tax system.

József Lukács:

HUNGARY: THE INTRODUCTION OF VAT IN 1988 446

The author, Director of the Department of Indirect Taxes, offers an explanation of the underlying theories pushing Hungary to develop a VAT system. He discusses the objectives of the VAT system, describes its general form and gives the tax rates.

L.W. Mamet:

U.S.S.R.: TAX ASPECTS OF JOINT VENTURES 452

The recent developments surrounding glasnost have resulted in increased interest in business opportunities in the U.S.S.R. The author discusses the recently enacted joint venture law and indicates some of the areas of major concern.

Howard M. Liebman:

U.S.A.: TAXATION OF EAST EUROPEAN-SOURCE JOINT VENTURE INCOME 460

The U.S. tax consequences of establishing a joint venture are reviewed. This article considers many of the problems of transferring tangible and intangible property. The author also provides overviews of the law of intercompany transfer pricing, foreign tax credits, liquidations and reorganizations and tax treaties.

Prof. Dr. Jan Głuchowski:

POLAND: TAX ASPECTS OF JOINT VENTURES WITH WESTERN COMPANIES TAKING INTO ACCOUNT TAX TREATIES CONCLUDED WITH OTHER COUNTRIES 467

After providing a historical review of the Polish tax system, the author discusses in detail the 1986 Tax Act. He concludes by offering some comments on the various Polish double taxation treaties.

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Miodrag Arsić:

YUGOSLAVIA: RELEVANT ASPECTS IN TAX LAWS AND TREATIES CONCERNING THE TAXING OF FOREIGN PERSONS 472

An overview of the conditions for investment by foreign persons in domestic organizations for joint venture purposes is given. Thereafter, relevant Yugoslav tax laws and special advantages contained in treaties for the avoidance of double taxation are reviewed.

Willem G. Kuiper:

EAST-WEST TAX TREATIES 477

The increasing exchanges between the East and the West have renewed interest in the various treaties concluded for the avoidance of double taxation. The author reviews the treaties presently applicable. He compares the many treaties with the 1963 OECD Draft and the 1977 OECD Model. The use of Cyprus for tax advantages when dealing with Eastern European countries is also discussed.

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INHALTSVERZEICHNIS

Prof. Dr. Tibor Nagy:

Gegenwärtige Trends bei der Einkommensbesteuerung in den Staaten Osteuropas 439
In den vergangenen Jahren haben die Länder Osteuropas ihre Steuersysteme durch entsprechende Reformen den wirtschaftlichen Gegebenheiten angepasst. Der Verfasser erläutert die Hintergründe dieser Änderungen und das Verhältnis der alten zu den neuen Systemen, wobei er insbesondere auf die Entwicklungen in den Steuersystemen der UdSSR und Ungarns eingeht.

József Lukács:

Ungarn: Die Einführung der Mehrwertsteuer im Jahr 1988 446
Der Verfasser, Direktor des Instituts für indirekte Steuern, erlautert die Beweggründe, welche die ungarische Regierung veranlassten, das Mehrwertsteuer-System zu übernehmen. Er zeigt die Zielsetzungen auf, bespricht das zugrundeliegende Konzept und nennt die Steuersätze.

L. W. Mamet:

UdSSR: Steuerliche Fragen zu Joint Ventures 452
Die kürzlichen Entwicklungen in der UdSSR, die eine wirtschaftliche Öffnung einschliessen, haben das Interesse für unternehmerische Aktivitäten in diesem Land geweckt. Die Verfasserin stellt das kürzlich eingeführte Joint Venture-Gesetz vor und erläutert seine wichtigsten Bestimmungen.

Howard M. Liebman:

USA: Die Besteuerung von Joint Venture-Einkünften aus Osteuropa 460
Die in den USA zu beachtenden Auswirkungen bei der Errichtung eines Joint Ventures werden in diesem Artikel aufgezeigt. Dabei wird eine Vielzahl von Problemen wie z.B. die Übertragung von materiellen und immateriellen Wirtschaftsgütern behandelt. Der Verfasser vermittelt auch einen Überblick über die Bestimmungen zu den Verrechnungspreisen, über die Anrechnung ausländischer Steuern, über die Behandlung von Liquidationen und Sanierungen sowie über die Anwendung der Doppelbesteuerungsabkommen.

Prof. Dr. Jan Głuchowski:

Polen: Steuerliche Aspekte bei Joint Ventures mit westlichen Unternehmen, unter Berücksichtigung der anzuwendenden Doppelbesteuerungsabkommen 467
Der Verfasser vermittelt zunächst einen historischen Überblick über das polnische Steuersystem. Danach erläutert er ausführlich das Steuergesetz von 1986. Er schliesst seinen Beitrag damit ab, dass er die verschiedenen polnischen Doppelbesteuerungsabkommen bespricht.

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Miodrag Arsić:

Jugoslawien: Die relevanten Aspekte der Besteuerung ausländischer Personen in den Steuergesetzen und den Doppelbesteuerungsabkommen 472
In diesem Artikel wird ein Überblick über die Bedingungen für Investitionen ausländischer Personen vermittelt. Danach werden die relevanten jugoslawischen Steuergesetze und speziellen Vergünstigungen dargestellt, wie sie in den Doppelbesteuerungsabkommen enthalten sind.

Willem G. Kuiper:

Doppelbesteuerungsabkommen zwischen Ost und West 477
Die zunehmende wirtschaftliche Zusammenarbeit zwischen den Staaten Osteuropas und den westlichen Ländern hat das Interesse an den bestehenden Doppelbesteuerungsabkommen wiederbelebt. Der Verfasser vermittelt einen Überblick über die derzeit bestehenden Doppelbesteuerungsabkommen und vergleicht diese mit den OECD Musterabkommen von 1963 und 1977. Auf die Zwischenschaltung von Zypern bei bestimmten Gestaltungen, die aus steuerlichen Gründen vorteilhaft sein kann, wird ebenfalls eingegangen.

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Professeur Dr. Tibor Nagy:

Développement récent de l'imposition des revenus en Europe de l'Est 439
Les années dernières les pays de l'Europe de l'Est ont modifié et réformé leurs systèmes fiscaux. L'auteur explique les fondements de ces changements de même qu'il expose la relation entre les vieux systèmes fiscaux et les nouveaux systèmes fiscaux en traitant le développement des systèmes fiscaux russe et hongrois.

József Lukács:

Hongrie: Introduction de la T.V.A. en 1988 446
L'auteur, Directeur de la Division des Impôts Indirects, nous donne une analyse des théories sous-jacentes qui ont poussé la Hongrie à développer un système de T.V.A. Il commente les objectifs poursuivis par le système de T.V.A., il décrit sa forme générale et en donne les différents taux.

L.W. Mamet:

URSS: Aspects fiscaux des sociétés en participation 452
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Howard M. Liebman:

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Les conséquences fiscales américaines de l'établissement d'une société en participation sont mentionnées dans cet article qui analyse par ailleurs les nombreux problèmes de transferts de propriétés immobilières et mobilières. L'auteur donne également un aperçu de la loi sur les prix de transfert inter-sociétés, les crédits d'impôts étrangers, les liquidations et réorganisations, et sur les conventions fiscales.

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CANADA: PROPOSALS FOR TAX REFORM **495**
The author provides a report and commentary covering the reform of Canadian personal and corporate tax measures as well as the new multi-stage sales tax with refundable sales tax credits. As in many of the recent tax reform proposals there is base-broadening combined with lower rates and an attempt to remain revenue neutral. The introduction of a value-added tax in Canada hails the landing of this tax in North America.

G.C.A. Smeets:

THE NETHERLANDS ANTILLES: THE NEW SHIP REGISTRATION TAX ACT **505**
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R.G.L. de Silva:

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IFA News:

Some Highlights from the Secretary General's 1986 Annual Report Presented at the Brussels Congress 1987 ..... **517**
Prof. Dr. Jan H. Christiaanse welcomed the new honorary treasurer and spoke of last year's IFA Congress. This is a brief review of the events at the 40th IFA Congress held in New York.

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XIIIth Symposium of the Latin American Tax Law Institute **522**
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I.W. Harris:

HONG KONG: THE SO CHAK KWONG CASE **523**
This recent case has provided much controversy for taxpayers whose families are resident in Hong Kong. The author illuminates the lacunae present in the Hong Kong law which allow non-business visits to Hong Kong to count in the determination of tax liability.

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Allan R. Lanthier:

Kanada: Vorschläge für eine Steuerreform *495*
Der Verfasser berichtet über die Vorschläge zur Reform der kanadischen Einkommen- und Körperschaftsteuer sowie über die auf den verschiedenen Stufen zu erhebende Umsatzsteuer unter gleichzeitiger Verrechnung der Vorsteuern. Wie in den meisten Steuerreformplänen anderer Länder wird eine Verbreiterung der Besteuerungsbasis mit einer Senkung der Steuersätze kombiniert, wobei die Auswirkungen auf das Steueraufkommen neutral sein sollen. Die Einführung der Mehrwertsteuer in Kanada dürfte den Nährboden für die Verbreitung dieser Steuerart in ganz Nordamerika bereiten.

G.C.A. Smeets:

Die Niederländischen Antillen: Das neue Schiffregister-Steuergesetz *505*
Der Verfasser vermittelt einen Überblick über das neue Schiffregister-Steuergesetz der Niederländischen Antillen, das am 3. September 1987 verabschiedet wurde. Dieses Gesetz enthält eine Option für eine jährliche Steuer auf der Basis der Tonnage, bzw. für die

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Allan R. Lanthier:

Canada: Propositions de réforme fiscale *495*
L'auteur communique un rapport accompagné d'un commentaire portant sur la réforme des dispositions fiscales concernant l'impôt canadien des personnes physiques et des sociétés ainsi que sur la nouvelle taxe sur le chiffre d'affaires à plusieurs niveaux et les crédits de taxe sur le chiffre d'affaires remboursables. Il y a, comme dans la plupart des propositions récentes de réformes fiscales, un élargissement de la base combiné à un abaissement des tarifs et un essai de demeurer fiscalement neutre. L'introduction de la T.V.A. au Canada lance un appel pour son implantation en Amérique du Nord.

G.C.A. Smeets:

Antilles Néerlandaises: La nouvelle loi fiscale sur l'enregistrement des navires *505*
L'auteur analyse en détail la nouvelle loi fiscale des Antilles Néerlandaises sur l'enregistrement des navires adoptée le 3 septembre 1987. La loi offre une option entre une imposition annuelle en fonction du tonnage et le maintien de l'ancienne méthode prévue par l'art. 9A

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Beibehaltung der bisherigen Methode nach Art. 9 A der Gewinnsteuer-Durchführungsverordnung 1940. Der Zweck dieses neuen Gesetzes ist darin zu sehen, dass die Niederländischen Antillen als Registrierort für Schiffe attraktiver werden sollen.

K.E. Etherington:

Grossbritannien: Verdeckte Gewinnausschüttungen *509*
Dieser Artikel untersucht zunächst die Gesetzgebung betreffend die Verrechnungspreise. Danach wird ein Blick auf das Problem der Unterkapitalisierung geworfen und das Verhältnis zwischen dem britischen Recht zu diesen Fragenkomplexen und den Doppelbesteuerungsabkommen im allgemeinen aufgezeigt. Schliesslich geht der Verfasser auf die speziellen Fragen im Zusammenhang mit Betriebstätten ein.

R.G.L. de Silva:

Sri Lanka: Kürzliche Änderungen im Steuerrecht *514*
Das wichtigste Steuergesetz von Sri Lanka, das Einkommensteuergesetz von 1979, wurde in den letzten 8 Jahren mehrfach geändert. Der Verfasser vermittelt einen Überblick über die bedeutendsten Änderungen: die neuen Sätze für die Steuer auf Veräusserungsgewinne, die Bestimmungen zur Abschreibung, die Vorschriften zur Einkommen- und Körperschaftsteuer sowie zu den nichtansässigen Unternehmen, under vieles andere mehr. Er rundet seinen Beitrag ab mit einem kurzen Kommentar zu den neuen Rechtsmittelvorschriften sowie den nachhaltig erhöhten Strafen für die Nichtabgabe von Steuererklärungen.

IFA Mitteilungen:

Einige Höhepunkte aus dem anlässlich der IFA-Konferenz 1987 in Brüssel erstatteten Jahresberichtes des Generalsekretärs *517*
Prof. Dr. Jan H. Christiaanse hiess den neuen Schatzminister willkommen und berichtete über den letztjährigen IFA-Kongress. Dieser kurze Bericht beleuchtet nogmals die Ereignisse des 40. IFA-Kongresses in New York.

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XIII. Symposium des Latin American Law Institutes *522*
Nichtoffizielle Übersetzung der beiden Resolutionen, die anlässlich des XIII. Symposiums, das 1987 in Palma de Mallorca stattfand, auf der Basis der Landesberichte und der Diskussion verabschiedet wurden. Die erste Resolution betrifft die „Abgrenzung sich berührender Steuerkompetenzen auf verschiedenen Regierungsebenen", und die zweite behandelt die „Verteilung öffentlicher Ausgaben zwischen den verschiedenen Regierungsebenen".

I.W. Harris:

Hong Kong: Der Fall So Chak Kwong *523*
Dieser kürzlich publik gewordene Fall betrifft die Kontroverse um solche Steuerpflichtige, deren Familien in Hong Kong ansässig sind. Der Verfasser beleuchtet die Lücke im Gesetz von Hong Kong, die es möglich macht, dass nichtgeschäftliche Besuche in Hong Kong bei der Bestimmung der Steuerpflicht berücksichtigt werden.

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de l'Ordonnance de 1940 sur l'imposition des bénéfices. L'objet de la nouvelle loi est d'augmenter l'intérêt de l'enregistrement aux Antilles Néerlandaises.

K.E. Etherington:

Royaume-Uni: Distribution occulte de bénéfices *509*
Cet article analyse la législation se rapportant au prix de transfert inter-sociétés ainsi que le problème de "thin capitalization" et le rapport, dans la loi britannique, entre "thin capitalization", prix de transfert inter-sociétés et, d'une façon générale, les conventions de double imposition. La situation de l'établissement stable est brièvement analysée à la fin de l'article.

R.G.L. de Silva:

Sri Lanka: Récentes modifications de la législation fiscale *514*
La loi fiscale la plus importante du Sri Lanka, le "Inland Revenue Act" de 1979, a été modifiée à plusieurs reprises au cours des 8 dernières années. L'auteur donne un aperçu des modifications les plus importantes, y compris les nouveaux taux de l'impôt sur les plus-values, les amortissements, l'impôt sur le revenu des personnes physiques, des sociétés résidentes et non-résidentes etc. L'auteur conclut en commentant rapidement la nouvelle procédure d'appel et la sanction largement modifiée qui est prévue en cas de défaut de déclaration de revenus.

Nouvelles de l'IFA:

Points importants du Rapport Annuel 1986 présentés par le Secrétaire Général au Congrès de Bruxelles de 1987 ..... *517*
Le Professeur Dr. Jan H. Christiaanse souhaite la bienvenue au nouveau Trésorier Honoraire et prononce quelques mots à propos du Congrès de l'IFA de l'an dernier. Ce petit article est un aperçu des points importants du 40ème Congrès de l'IFA qui s'est tenu à New York en 1986.

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XIIIe Symposium de l'Institut de la Législation Fiscale en Amérique Latine *522*
Traductions non-officielles de deux résolutions prises à la suite des discussions et de la lecture des Rapports Nationaux qui ont eu lieu lors du XIIIe Symposium à Palma de Majorque en 1987. La première résolution porte sur l'"Attribution de compétences fiscales entre différents niveaux gouvernementaux" et la seconde sur la "Distribution des dépenses publiques entre les différents niveaux gouvernementaux".

I.W. Harris:

Hong-Kong: Le cas So Chak Kwong *523*
Ce cas récent a provoqué de nombreuses controverses au sujet des contribuables dont les familles résident à Hong-Kong. L'auteur met en évidence la lacune de la loi de Hong-Kong qui permet de tenir compte des visites non-professionnelles à Hong-Kong dans le calcul de la détermination de l'assujettissement à l'impôt.

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H. Arnold Sherman:

THE ARGENTINE WEALTH TAX AND ITS TRANSBORDER EFFECTS – or tax foreigners – they have no vote 536

In 1985 Argentina amended its wealth tax legislation and henceforth included individual foreign shareholders having an indirect interest (e.g. through a multinational company having an affiliate in Argentina). The author believes this to be an improper extension of extraterritorial application of the law and expresses his surprise that a country which is dependent on foreign investment would introduce such taxation.

Jean-Marc Tirard:

MOROCCO: THE PRESENT STATUS OF TAXATION INCLUDING RECENT TAX REFORM 542

The author reviews the basic taxes, both corporate and individual, currently in effect in Morocco including the new VAT. He provides a list of the countries with which Morocco has concluded Conventions for the Avoidance of Double Taxation and a table of all dividends, interest and royalties withholding tax rates applicable.

Howard M. Liebman and Carol A. Kunze:

THE MARIANA ISLANDS: AN UPDATE ON TAXATION .. 549

With the passage of the Tax Reform Act 1986 in the United States, the mirror-image requirement for U.S. possessions has been repealed. This will allow the Mariana Islands to develop their own tax code which will more closely reflect the unique needs of the island economy. The authors review the legislation and the situation after TRA 1986.

Prof. Dr. Tibor Nagy:

VIET-NAM: CHANGES IN THE TAX SYSTEM 554

The author gives a brief review of the tax laws proposed at the Fifth Congress of the Viet-Namese Communist Party. Changes in the taxes on State enterprises, agricultural activities, private organizations and persons are discussed, as well as an overview of the new joint venture law.

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Montri Hongskrailers:

THAILAND: TAXATION OF JOINT VENTURES 557

The author reviews the laws governing joint ventures in Thailand. He begins by defining a joint venture by means of the Revenue Code and then he discusses formation. Thereafter he deals with the tax consequences of such a business. Mr. Hongskrailers concludes by using a question and answer technique to inform the reader of some important accounting problems.

Prof. Arye Lapidoth:

ISRAEL: THE 1987 TAX REFORM 561

The author provides an overview of the many reforms planned for the Israeli tax system. These changes include lowered corporate and individual income tax rates, and a lower tax rate on dividends. The treatment of "approved enterprises" is discussed as well as a modified capital gains tax.

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H. Arnold Sherman:

L'impôt argentin sur la fortune et ses effets internationaux – ou Etrangers: contribuables, oui mais sans droit de vote *536*

L'Argentine a modifié en 1985 sa législation concernant l'impôt sur la fortune et l'a étendue aux personnes physiques actionnaires étrangères ayant un intérêt indirect (entre autres par l'intermédiaire d'une société multinationale ayant une filiale en Argentine). L'auteur pense qu'il s'agit d'une extension impropre de l'application extra-territoriale de la loi, il est surpris qu'un pays tributaire d'investissements étrangers introduise une telle imposition.

Jean-Marc Tirard:

Maroc: Situation actuelle de l'imposition, y compris la réforme fiscale *542*

L'auteur analyse différents impôts fondamentaux, y compris la TVA, applicables actuellement au Maroc aussi bien aux personnes physiques qu'aux personnes morales. Une liste des différents pays avec lesquels le Maroc a conclu des conventions tendant à éviter les doubles impositions ainsi qu'un tableau mentionnant les taux de retenues à la source applicables aux dividendes, intérêts et redevances sont joints à cet article.

INHALTSVERZEICHNIS

H. Arnold Sherman:

Die Vermögensteuer in Argentinien und ihre Auswirkungen in grenzüberschreitenden Situationen, oder: Steuerausländer haben kein Stimmrecht *536*

Im Jahre 1985 änderte Argentinien seine Gesetzgebung zur Vermögensteuer und bezieht seither solche ausländische natürliche Personen in die Besteuerung ein, die indirekt Anteile in Argentinien besitzen (z.B. via eine multinationale Gesellschaft mit einer Tochtergesellschaft in Argentinien). Der Verfasser glaubt, dass dies eine ungerechtfertigte Ausdehung der extraterritorialen Gesetzesanwendung darstellt, und er zeigt sich überrascht, dass ein Land, das so sehr von ausländischem Kapital abhängig ist, eine derartige Besteuerung vorsieht.

Jean-Marc Tirard:

Marokko: Der gegenwärtige Stand des Steuersystems, unter besonderer Berücksichtigung der Steuerreform *542*

Der Verfasser bespricht die wichtigsten Steuerarten, die derzeit in Marokko erhoben werden, nämlich die Körperschaft- und Einkommensteuer sowie die neue Mehrwertsteuer. Ferner vermittelt er einen Überblick über die Doppelbesteuerungsabkommen, die Marokko abgeschlossen hat, wobei er eine Tabelle mit den relevanten Quellensteuersätzen für Dividenden, Zinsen und Lizenzgebühren anschliesst.

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Howard M. Liebman et Carol A. Kunze:

Iles Mariannes: Mise à jour de l'imposition 549
L'introduction aux Etats-Unis de la loi sur la réforme fiscale de 1986 a supprimé la nécessité d'un système fiscal identique applicable aux possessions américaines, permettant ainsi aux îles Mariannes de développer leur propre code fiscal. Celui-ci reflètera plus exactement les besoins d'une économie insulaire. Les auteurs analysent la législation ainsi que la situation existantes après la réforme de 1986.

Prof. Tibor Nagy:

Viet-Nam: Modifications du système fiscal 554
L'auteur donne un rapide aperçu des lois fiscales proposées lors du 5ème Congrès du Parti Communiste Vietnamien. Il commente les modifications apportées aux impôts dus par les entreprises nationales, les secteurs d'activités agricoles, les organisations privées et les personnes physiques; il analyse rapidement par ailleurs la nouvelle loi sur les sociétés en participation.

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Montri Hongskrailers:

Thaïlande: Imposition des sociétés en participation 557
L'auteur analyse les différentes lois portant sur les sociétés en participation en Thaïlande. Il commence par définer une société en participation en suivant le Code Fiscal, puis commente sa formation et enfin analyse les conséquences fiscales d'une telle entreprise. M. Hongskrailers termine en utilisant la technique des questions/réponses pour informer le lecteur de quelques problèmes importants de comptabilité.

Prof. Arye Lapidoth:

Israël: Réforme fiscale de 1987 561
L'auteur passe en revue les nombreuses réformes prévues par le système fiscal israélien; ces modifications comprennent une diminution des taux de l'impôt sur les sociétés ainsi que sur les revenus des personnes physiques et un impôt plus faible sur les dividendes. Il étudie également le traitement des "entreprises agréées" ainsi que l'impôt sur les plus-values tel qu'il a été modifié.

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Howard M. Liebman und Carol A. Kunze:

Die Mariannen-Inseln: Neue Entwicklungen im Steuerrecht 549
Durch eine entsprechende Vorschrift im Steuerreform-Gesetz 1986 (TRA 1986) der USA wurde das Erfordernis der „spiegelbildlichen Gesetzgebung" für die US-Besitzungen fallengelassen. Dies wird die Mariannen-Inseln in die Lage versetzen, ein eigenes Steuersystem zu entwickeln, das den Erfordernissen einer Inselwirtschaft in angemessener Weise Rechnung tragen wird. Die Verfasser stellen die Gesetzgebung vor und erläutern die Situation nach Inkrafttreten von TRA 1986.

Prof. Dr. Tibor Nagy:

Vietnam: Änderungen im Steuersystem 554
Der Verfasser vermittelt einen kurzen Überblick über die Steuergesetze, die beim 5. Kongress der Kommunistischen Partei Vietnams vorgeschlagen wurden. Es werden die Änderungen für die Steuern bei den Staatsunternehmen, den landwirtschaftlichen Betrieben, den privaten Organisationen und Personen besprochen; ferner wird ein Überblick über das neue Gesetz zu den Gemeinschaftsunternehmen gegeben.

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Montri Hongskrailers:

Thailand: Die Besteuerung von Gemeinschaftsunternehmen 557
Der Verfasser erläutert die Gesetze zu den Gemeinschaftsunternehmen in Thailand. Zunächst definiert er den Begriff „Gemeinschaftsunternehmen" anhand des Steuergesetzes, um danach mit Fragen zur Gründung eines solchen Unternehmens und der Besprechung der relevanten Steuerfragen fortzufahren. Herr Hongskrailers wendet ein Fragen- und Antwort-Verfahren an, um die Leser auf einige wichtige Probleme im Rechnungswesen aufmerksam zu machen.

Prof. Arye Lapidoth:

Israel: Die Steuerreform 1987 561
Der Verfasser vermittelt einen Überblick über die verschiedenen Reformmassnahmen, die in Israel geplant sind. Diese Änderungen beinhalten niedrigere Steuersätze bei der Körperschaft- und Einkommensteuer sowie einen niedrigen Steuersatz für Dividenden. Ferner wird die Behandlung von „genehmigten Unternehmen" als auch die modifizierte Besteuerung der Veräusserungsgewinne besprochen.

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U.S. Branch Taxation: A Venture into the Unknown

By Richard M. Hammer and William D. Rohrer

The extension of U.S. taxing jurisdiction over dividends and interest paid by *foreign corporations* "doing business" in the United States has been the subject of criticism in other countries for many years.[1] No other country, to the best of our knowledge, has had such a rule in its tax legislation. In reality, however, such extraterritorial taxing jurisdiction over a non-resident payor, which has become known in tax jargon as "secondary withholding", is generally more favorable to foreign corporations with U.S. branches than will be the new branch tax,[2] and it provides (or will provide in those limited cases where it is retained, at least temporarily) such corporations with a competitive advantage vis-à-vis foreign corporations with U.S. subsidiaries.

Endeavoring to eliminate this competitive edge (and, perhaps, to respond to those who criticized the extraterritorial character of the secondary withholding tax), the U.S. Congress enacted the new branch level tax.[3] Then, in the same Act, Congress extended its extraterritorial taxing jurisdiction by subjecting to U.S. tax any gains derived from the sale of U.S. business assets, within ten years after being used in such business, regardless of the fact that those assets may have been removed from U.S. taxing jurisdiction, and the seller may have entirely ceased doing any kind of business in the U.S., years before the assets were sold.[4]

Both of these provisions may be "more bark than bite" – at least for the near term – because of treaty provisions which counteract their effect. Admittedly, their potential, long-range impact is significant;[5] but every U.S. income tax treaty selectively restricts, at least to *some* degree, their applicability.

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Mr. Rohrer is a manager of the International Tax Services Group in the National Office of Price Waterhouse, New York. He is a graduate of the Ohio State University colleges of business and law, and is a member of the American Bar Association and Institute of CPA's. Mr. Rohrer is a frequent lecturer and has authored many articles on international taxation.

1. See, for example, Report of the OECD Committee on Fiscal Affairs, "Model Double Taxation Convention on Income and on Capital" (OECD Model Treaty), Article 10(5) "Dividends", and related commentary, p. 96, paragraphs 32 and 33; see also Exhibit A for a list of those treaties which prohibit the U.S. secondary withholding tax.
U.S. residence jurisdiction – based on place of incorporation – is extremely limited. U.S. "doing business" jurisdiction over a non-resident payor is really an attempt by the U.S. to broaden its jurisdiction to approximate, or perhaps exceed, traditional notions of residency in other countries – based on place of management and control.
2. Under the secondary withholding rules, no withholding taxes are assessed until the foreign corporation actually distributes its profits. Therefore, the U.S. branch may remit, and its foreign home office may make use of, the branch's profits without being subjected to the tax. However, under the branch level tax rules, the branch tax will be assessed when the branch's profits are remitted to the home office – a real timing difference. In addition, the secondary withholding rules only apply when a majority of the income of the foreign corporation is derived from its U.S. branch. Thus, a foreign corporation that derives a substantial amount of U.S. income, but also operates extensively in other countries, may not be liable for the secondary withholding tax. The branch level tax, on the other hand, applies regardless of the amount of income earned by the U.S. branch relative to the total income of the foreign corporation of which it is a part.
3. Act Section 1241(a) adding IRC Sec. 884 "Branch Profits Tax". Thus, the U.S. joins the small handful of other countries imposing a branch tax such as Australia, Canada and France.
4. Act Section 1242, amending IRC Sec. 864(c), treats such gains *as if* they are effectively connected with the conduct of a U.S. trade or business. This rule is analogous to the 10-year rule for U.S. citizens who revoke their citizenship to avoid U.S. taxes (Sec. 877), as well as the 3-year rule for resident aliens who temporarily become non-residents (Sec. 7701(b)(9)).
5. The combined (U.S. income tax and branch profits tax) effective tax rate could be as high as 53.8%, once the new corporate tax rates are fully phased in. These provisions are estimated to generate well over $ 100 million in government revenues for the next five years.

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Even though new statutory "treaty shopping" rules generally limit the availability of a U.S. treaty to foreign corporations that reside in the other Contracting State (as will be discussed below), exceptions to the treaty shopping rules, as well as the definition of treaty shopping itself, provide a considerable degree of flexibility. In any event, the new provisions in the Act do represent potential obstacles which the foreign investor cannot ignore in planning U.S. business activities.

Before discussing the effect of U.S. treaties upon these new provisions (or vice versa), we will provide an overview of the new rules as well as some of the nuances and unanswered questions associated with their application.

THE NEW BRANCH LEVEL TAX (BLT)

New Section 884, entitled "Branch Profits Tax," is in reality two supplemental taxes – a 30% self-assessed secondary tax on profits[6] and a 30% withholding tax on interest payments/deductions.[7] Both taxes, which are assessed in addition to the regular corporate income tax, effectively treat a foreign corporation's U.S. branch, in many respects, like a hypothetical U.S. corporation owned by its head office. As a general matter, the BLT on profits is only assessed when profits are not retained for business use within the branch. In other words, the BLT is an attempt to tax profit remittances to the foreign corporation's home office, equating such remittances to dividend payments by a U.S. subsidiary to its foreign parent corporation. Similarly, the BLT on interest is assessed, through withholding at source, on actual or "deemed" interest remittances by the branch.

A. Branch tax on profits

The BLT on profits, which generally replaces the secondary withholding tax on dividends, is imposed on the "dividend equivalent amount" (DEA) of a foreign corporation's U.S. branch. The DEA is equal to the branch's "effectively connected earnings and profits" (EC/E&P), adjusted to reflect yearly increases or decreases in "U.S. net equity." In effect, the tax base is reduced (but not below zero) for reinvested earnings, and increased for any disinvestment (but only to the extent that it was previously reduced by prior reinvestment). As a result, current earnings that are not reinvested will be subject to the tax even though the branch may have accumulated deficits from prior years.[8]

EC/E&P, a defined term in Sec. 884(d), is not synonymous with effectively connected taxable income (EC/TI).[9] EC/TI will generally be used, however, as the starting point for arriving at EC/E&P.[10] Under the existing E&P rules, EC/TI will be increased for items which represent economic income, such as municipal bond interest income which is exempt from the U.S. corporate income tax, and for those items which represent tax, but not economic, deductions, such as the excess of accelerated depreciation over straight-line depreciation. Similarly, decreases are allowed for items of economic expense which are not otherwise currently deductible for income tax purposes (e.g. capital losses in excess of capital gains); but decreases are *not* permitted for profit remittances to the home office (or else the whole purpose of the BLT would be defeated). EC/E&P is also reduced by regular U.S. and foreign income taxes attributable to the branch's EC/TI.[11]

"U.S. net equity" is money and the aggregate adjusted bases of property (for purposes of computing E&P), less liabilities, that are treated as connected with the conduct of the branch's U.S. business. The BLT, therefore, is not technically a remittance based tax since the accumulation of income beyond the branch's reasonable "business needs" in non-business property, such as passive investments, will not reduce the dividend equivalent amount (i.e. will effectively be treated as remitted).

Interestingly, the BLT on profits is exigible whenever a foreign corporation generates profits from a "U.S. trade or business" – a very low threshold indeed, particularly in view of what traditional notions of the terms "branch" or "establishment" contemplate (i.e. an unincorporated business unit which amounts to a separate profit center, usually with some investment in assets). Presumably, any U.S. trade or business, which has no nexus in the U.S. (e.g. the carrying on of periodic business activities in the U.S. from a foreign base) will be deemed to have distributed all of its earnings (i.e. made no reinvestment) and, therefore, will be subject to the BLT on the entire amount of its effectively connected E&P. The "permanent establishment" threshold will eliminate such a harsh result for foreign corporations resident in countries having an income tax treaty with the U.S.

It should also be noted that the branch level tax will apparently apply to foreign corporations that are partners in a partnership (U.S. or foreign) that derives income effectively connected with a U.S. trade or business.[12] Since the BLT on profits would apply at the partner level, based on general conduit principles which have the corporate income tax applying at that level, the determination as to whether a particular

6. New Sec. 884(a).
7. New Sec. 884(f).
8. This is equivalent to the so-called "nimble dividend" rule in Sec. 316(a)(2) which applies to corporate distributions.
9. Foreign corporations may now have to make three separate tax computations: (1) effectively connected taxable income for purposes of the U.S. corporate income tax; (2) effectively connected earnings and profits for purposes of the BLT on profits; and (3) alternative minimum taxable income for purposes of the alternative minimum tax.
10. See Rev. Proc. 75-17, 1975-1 C.B. 677 wherein the sample computation of E&P starts with taxable income.
11. Even though foreign taxes may not be credited against the BLT, they may apparently be used to reduce the tax base. Act Section 1241(c) amending IRC Sec. 906.
12. The Senate Finance Committee Report on H.R. 3838, General Explanation, specifically addresses this issue. The Conference agreement provides that it generally follows the Senate bill with respect to the branch profits tax.

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treaty permits the branch profits tax in any given case will also be made at the partner level individually by each foreign corporate partner (using the relevant treaty for each such foreign partner). If it is determined that the branch tax does apply to a particular foreign corporate partner, the BLT computation by that partner should not be too complex provided that the partnership is willing to supply all the necessary additional information.

B. Branch tax on interest

In the post-1986 statutory scheme, the BLT on interest replaces the secondary withholding tax on interest which, under pre-1987 rules, was imposed on interest paid by a foreign corporation over 50% of whose gross income from all sources was effectively connected to its U.S. trade or business. As will be seen below, the BLT on interest completely eliminates any such threshold.

The interest application of the BLT basically looks at two factors:

(1) the interest actually paid by the branch itself,[13] and
(2) the excess of the deductible interest of the branch, as the result of the application of a special interest expense allocation rule contained in Reg. Sec. 1.882-5 (under which certain interest expense of the home office will be ascribed, at least in part, to the U.S. branch), over such interest actually paid in (1) above.

The interest actually paid by the branch itself is "treated as if it were paid by a domestic corporation" to the actual foreign recipient, thus making it U.S.-source interest income to the recipient to be subjected to a 30% U.S. withholding tax (unless statutorily exempt or reduced by a U.S. treaty with the foreign recipient's country). The excess amount (i.e. the total Reg. Sec. 1.882-5 interest deduction less interest actually paid) is treated as if it were paid to the "foreign corporation by a wholly-owned domestic subsidiary corporation on the last day of such foreign corporation's taxable year," again making it U.S.-source interest income to the hypothetical parent corporation to be subjected to a 30% U.S. withholding tax (unless statutorily exempt or reduced by a U.S. income treaty with the country of the foreign corporation's residence).[14]

It is not clear, at this time, whether, and to what extent, the excess interest "deemed paid" by the branch to the home office will qualify for any U.S. statutory tax exemptions, such as, for example, those presently attaching under appropriate circumstances to interest on foreign-held portfolio debt issues or interest on bank deposits. The legislation leaves this issue for regulations, but the background reports suggest that it be handled by calculating, for *each* type of external borrowing entered into by the foreign corporation, the ratio of the principal amount of such borrowing *to* the aggregate of all such borrowings, and apportioning the "excess interest" in accordance with the resulting ratios – a complex exercise to say the least.[15] It also seems logical that reference should be made to the nationality of the ultimate recipients of interest payments by the home office, since excess interest "deemed paid" by the branch, but actually paid by the home office to a U.S. person, should not be subjected to U.S. withholding tax. Neither the Code nor the background reports address this issue. Admittedly, this would also be an extremely complex task.

Whether it is preferable to have larger actual interest payments so as to have little or no excess interest deduction under the Sec. 882 Regulations, or smaller actual interest payments so as to have a larger excess interest deduction figure, will depend, to a great extent, on a comparison of the U.S. income tax treaty(ies) with the actual interest recipient's country(ies) of residence (in the case of actual interest payments by the branch) *to* the U.S. treaty with the country of residence of the foreign corporation itself (in the case of an excess interest deduction "deemed paid" to the home office). Of course, any interest actually paid by the branch to a U.S. resident will be exempt from the BLT on interest – perhaps the surest way to avoid any BLT on actual interest payments. It should also be noted that the branch level tax on interest can technically apply even though neither the branch nor the home office are profitable (which would equate with the application of the statutory withholding tax on interest paid abroad by an unprofitable U.S. subsidiary of a foreign corporation)

The statutory language would also appear to require that actual branch payments of interest in excess of allowable interest deductions (i.e. the reverse of the situation discussed above) be subjected to the BLT withholding rules for interest. Such an interpretation of the new rules, however, would be inequitable and illogical since the non-deductible excess payment of interest will reduce the branch's net equity, and thereby increase its dividend equivalent amount, causing the same amount to be taxed again, at the 30% rate, under the BLT on profits. This would introduce unnecessary (and inequitable) double taxation. For example, assume a U.S. branch has the following balance sheet at the beginning of the year:

Cash	$ 20	Debt	$ 50
Other assets	80	Home office account	50
	$100		$100

13. This is a curious digression from the Treasury regulations which have always considered interest to be "fungible" and, therefore, not definitely related to a particular activity. See also Rev. Rul. 78-423, 1978-2 C.B. 194, in which a U.S. branch of a Japanese bank was not allowed to deduct its actual interest payments as though it were a separate entity.

14. The excess interest deduction, in effect, represents a payable from the branch to the home office. As a result, this liability can be paid (i.e. a remittance can be made) to the home office without triggering any BLT on profits.

15. The Conferees indicate that "actual debtor-creditor relationships for funds between a branch and a home office" may be established in certain circumstances, but, at the same time, the Conferees express concern "that taxpayers may artificially structure" such loans "in a manner different from their external liabilities in an attempt to reduce or eliminate the tax on excess interest." Ultimately, the Conferees leave the matter for regulatory resolution.

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Assume further that, for the year involved, the U.S. branch has EC/E&P of $ 100 before any interest deduction. The allocable interest deduction under Reg. 1.882-5 is $ 20, but actual interest payments by the branch are $ 25. Therefore, EC/E&P after the interest deduction is $ 80; but the increase in U.S. net equity is only $ 75 ($ 100 of income less actual interest payments of $ 25), resulting in the following balance sheet at the end of the year:

Cash ($ 20 + $ 75)	$ 95	Debt	$ 50
		Home office account	
Other assets	80	($ 50 + $ 75)	$125
	$175		$175

The "dividend equivalent amount" is $ 5 ($ 80 of EC/E&P, less reinvestments of $ 75), which is subject to the BLT on profits. This same $ 5 figure, which also represents the excess of actual interest payments ($ 25) over the allowable interest deduction ($ 20), also appears to be subject to the BLT on interest. Hopefully, regulations will eliminate this "double branch tax" anomaly.[16]

Withholding tax on the excess interest may also be prohibited under many treaties since this excess payment, arguably, is not "borne by" (i.e. deductible by) the branch. (This issue is discussed in more depth below.)

DEFERRED PAYMENTS AND APPRECIATED BUSINESS ASSETS

Income that is effectively connected with a foreign taxpayer's U.S. trade or business is taxed in the U.S. on a net income basis. However, U.S.-source income of a foreign taxpayer that is not effectively connected with a U.S. trade or business is generally subject to a 30% tax, withheld at source, on the gross income amount (unless reduced or eliminated by a Code provision or treaty). Non-effectively connected *gains*, on the other hand, are not subject to U.S. tax. Under prior law, foreign persons were able to avoid U.S. tax on income attributable to a U.S. trade or business in situations in which they received the income in a year *after* the close of the year in which trade or business had ceased to exist and during which year they were not engaged in any other U.S. trade or business (e.g. by selling property and recognizing the gain on the installment basis).

Under Section 1242 of the Act, any item of income or gain received by a foreign person which is attributable to a transaction undertaken in any other taxable year is treated as effectively connected with the conduct of a U.S. trade or business *if it would have been so treated had it been taken into account in such other year*. Thus, accelerating or deferring the recognition of income into a year in which the foreign person is not engaged in a U.S. trade or business will no longer change the manner in which the U.S. tax system treats the item of income, i.e. the rules will no longer exempt an item of income that might otherwise have been fully taxed in a different taxable year.

In addition, if any assets are sold by a foreign taxpayer within 10 years after being used in a U.S. trade or business, the gain will be treated as if it were effectively connected.[17] The Senate Bill would have taxed such business assets upon their removal from U.S. jurisdiction (e.g. upon distribution to the home office),[18] but, as a matter of equity, the bill would also have provided, reciprocally, a basis step-up for assets brought into the U.S.[19] The Conferees, however, were concerned about potential revenue losses caused by the basis step-up feature if it were available for depreciation purposes as well as for gain calculation purposes, and they therefore opted for the 10-year rule with *no basis step-up*. This "carry-over basis" rule, however, may unfairly cause any unrealized gain, which accrued on an asset while it was held by the foreign corporation prior to its transfer to the U.S. branch, to be within the realm of the 10-year provision. Again, perhaps regulations can mitigate this inequitable result.[20]

TREATY RESTRICTIONS ON APPLICATION OF NEW PROVISIONS

A. Elimination of branch profits tax

1. Permanent establishment

If an applicable income tax treaty precludes the United States from imposing its *regular corporate income tax* on income effectively connected with a U.S. trade or business, the BLT will not be imposed either (e.g. when the foreign corporation is engaged in a U.S. trade or business which *does not rise to a level of a U.S. permanent establishment*). For most business activities, the "permanent establishment" threshold is a higher standard than the "U.S. trade or business" threshold. Thus, a treaty will prevent such lesser activities (those which would not create a permanent establishment) from being subjected to immediate branch level taxation. Furthermore, the "attributable to" language found in most treaties is more generous to a foreign taxpayer than the "effectively connected" principle applied in the Code since the treaty language

16. A workable result would be to treat the excess of actual interest payments over allocable interest deductions as a constructive dividend to the home office, thereby subjecting such amount only to the branch tax on profits. Support for this approach can be derived from the title to 884(f) itself referring to the "Treatment of Interest *Allocable to Effectively Connected Income*." Since the excess actual interest payments are not deductible, they certainly are not allocable either. Unfortunately, the text of the statute itself is not so clear.
Another approach would be to treat the branch as an agent (i.e. a conduit) with respect to the excess. The branch would record a receivable (from the home office) for the excess payment, thus increasing its U.S. net equity. As a result, only the branch level tax on interest will apply – at least until such a time as the receivable is effectively forgiven by the branch.
17. See note 4, supra.
18. This would have brought branch distributions within the realm of the Act's repeal of the remaining vestiges of the so-called *General Utilities* doctrine.
19. Conceptually similar to the Canadian "landed basis" treatment which provides a basis step-up for *all* purposes, including depreciation.
20. One approach may be to allow the home office to make an arm's-length sale of any appreciated business property to its U.S. branch.

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does not permit application of the residual "force of attraction" principle present in Sec. 864(c)(3).[21]

2. Non-discrimination provision

Congress did not intend the BLT on profits to apply in situations where its application would be inconsistent with (and prohibited by) any existing U.S. income tax treaty obligations. Both the Senate Report and the Conference Report refer to the Treasury Department's interpretation of the non-discrimination article contained in the U.S. 1981 Model Income Tax Treaty[22] "to preclude the imposition of" the branch profits tax even though the income in question is subject to the regular corporate income tax (as attributable to a permanent establishment). The Conference Report refers specifically to paragraph 3 of the non-discrimination article (Article 24) which separately provides that a U.S. *permanent establishment"* of a resident of the other signatory nation shall not be treated any less favorably than a U.S. corporation. Many of our older treaties do not contain this particular paragraph, and, accordingly, many commentators have opined that these older treaties may not prevent the application of the BLT. This viewpoint, however, would seem to render the non-discrimination provisions in these older treaties virtually meaningless in a business profit context – clearly not the treaty negotiators' intent.[23] It is our view that these older conventions, which reflected the prevailing treaty language and phraseology at the time they were negotiated and executed, were intended to encompass (and prevent) *all* discrimination, including the application of a BLT, and they should be interpreted accordingly.

The older treaties briefly state that "*citizens* or *subjects* of one of the Contracting States [e.g. foreign corporations] shall not, while *resident* in the other Contracting State, be subjected therein to other or more burdensome taxes than are the citizens or subjects of such other Contracting State residing in its territory [e.g. U.S. corporations]." (Emphasis added.) The issue is whether a foreign corporation with a U.S. permanent establishment is considered to be a *resident* of the U.S. The relevant treaties do not, however, define this term. While taxing jurisdiction, from a U.S. perspective, is generally defined in the newer treaties as place of incorporation,[24] this definition appears only in those modern treaties which *also* contain the "permanent establishment" language as a separate paragraph in the non-discrimination article.

Most treaties generally provide that any term not otherwise defined within the treaty itself shall, unless the context otherwise requires, have a meaning which it has under the laws of that Contracting State whose taxes, which are the subject of the Convention, are at issue.[25] In short, this means that, since U.S. tax is involved, we must generally refer to U.S. law to determine the meaning of the term "resident". The U.S. Code does not contain an "all purpose" definition of the term "resident," at least insofar as it applies in the corporate environment.[26] In fact, in such an environment there is no need for such a definition in the law since the term itself is so infrequently used. The United States asserts its taxing jurisdiction based on either (1) incorporation in the U.S. or (2) "doing business" in the U.S.; but it is *not* based on any notion of the U.S. residency.

In tracking back through the history of the U.S. tax code, as it impacts upon foreign taxpayers engaging in a U.S. trade or business, it is obvious that the 1966 Foreign Investors Tax Act (FITA) resulted in some very fundamental changes. FITA completely renovated the U.S. tax regime for foreigners. It structurally moved the U.S. away from a "force of attraction" concept to an "effectively connected" concept. Prior thereto, foreign corporations engaging in U.S. trade business activities were referred to (in the title to Section 882) as *resident* foreign corporations. This terminology was in the Internal Revenue Code at the time our older treaties were negotiated, and it would appear to explain the language contained in the non-discrimination clause of the older treaties. Most importantly, it withstands the test of logic. Without such interpretation, foreign corporations, even those operating businesses in the U.S., would never be able to avail themselves of a treaty's non-discrimination article, leaving the protection conferred by that article solely to individuals. This makes no sense, and it is difficult to conclude that the treaty negotiators, particularly those on the non-U.S. side, would have concurred with such an interpretation.[27] Accordingly, we

21. Sec. 864(c)(3), and the regulations thereunder, provide that *any* U.S.-source income of a foreign taxpayer that is not fixed and determinable within the meaning of Sec. 871(a)(1) shall be treated *as if* it is effectively connected with the conduct of the taxpayer's U.S. trade or business whether or not it, in fact, is. Such income is not, however, considered to be "attributable to" the taxpayer's U.S. permanent establishment under an applicable income tax treaty unless an *actual* connection exists. See Rev. Rul. 81-78, 1981-1 C.B. 604.

22. Article 24 of the United States 1981 Model Income Tax Treaty (U.S. Model Treaty).

23. See Exhibit A for those U.S. income tax treaties whose non-discrimination articles do not contain "permanent establishment" terminology but, instead, refer to "citizens and subjects."

24. See Article 4(3), "Residence," of the U.S. Model Treaty. In actuality, many U.S. treaties which do contain a residence article contain *two* definitions of corporate residence: one for the U.S., based on place of incorporation, and another for the treaty partner, generally based on place of management and control. This "double definition" can (due to an inability to compromise, or at least develop a "tie breaker") frequently cause a corporation to be a resident of both countries, i.e. a "dual resident" corporation. See also Article 4(3), "Resident," of the OECD Model Treaty and related commentary, p. 57, paragraph 22, which states that "[i]t would not be an adequate solution to attach importance to a purely formal criterion like registration."

25. E.g., see Article 2(2), "General definitions," of the U.S.–France Income Tax Treaty.

26. Sec. 7701(b) establishes a statutory rule for determining residency of alien individuals, but not other legal persons (including corporations). While Reg. Sec. 1.861-2(a)(2) defines the term "resident" – and, interestingly, defines it to include ". . .(iv) a foreign corporation. . . engaged in a trade or business in the United States," – the Regulations specifically provide that the definition applies only for purposes of the interest income sourcing rules. The 1986 Tax Reform Act finally added a statutory definition of the term, again for purposes of the sourcing rules only, which is based solely on place of incorporation.

27. It should also be noted that paragraph (i) of Sec. 897 (Disposition of investment in United States real property) provides that foreign corporations holding a "U.S. real property interest" may elect to be treated as a

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believe that *all* U.S. treaties containing a non-discrimination clause preclude the BLT on profits (unless otherwise provided elsewhere within the treaty).

Neither the Act, nor the background legislative reports, address the interaction of the BLT with any other U.S. treaties which are not income tax treaties, such as treaties of Friendship, Commerce and Navigation (FCN treaties).[28] Most FCN treaties contain a non-discrimination article dealing explicitly with direct taxes.[29] Interestingly, most of these treaties specifically refer to "companies [of one Party] *engaged in trade*. . . within the territories of the other Party," not to companies of one Party which are "resident" within the territories of the other Party. Therefore, a foreign corporation with a U.S. PE should also be entitled to avail itself of a non-discrimination provision in an applicable FCN treaty.[30]

3. Secondary withholding prohibition

Where a treaty with any country contains a non-discrimination provision, effectively prohibiting the BLT on profits, but such treaty allows the secondary withholding tax, the secondary withholding rules will continue to apply. For the application of this approach, the foreign corporation must derive 25% or more of its gross income, over the preceding 3 years, from a U.S. permanent establishment (reduced by the 1986 Act from the "50% or more" level extant in pre-1987 rules).[31] If less than 25% of a foreign corporation's gross income is derived from a U.S. permanent establishment, no secondary withholding tax will be imposed.

Some treaties *permit* a secondary withholding tax, but specifically contain the 50% threshold from prior law, as opposed to the new 25% standard.[32] In such a case, we believe, the 50% threshold should take precedence over the new statutory rules and thus continue to apply.

Should an income tax treaty prohibit both the BLT and the secondary withholding tax, neither tax will be imposed (subject to treaty shopping qualifications discussed below).[33] The Dutch treaty is particularly noteworthy in this respect, since it has a non-discrimination article (which, incidentally, refers specifically to permanent establishments) as well as a prohibition against the secondary withholding tax.

B. Elimination of branch tax on interest

1. Permanent establishment

As with the application of the BLT on branch profits, the BLT withholding tax on interest will not be imposed with respect to activities which do not rise to the level of a permanent establishment under any income tax treaty. It is here where it becomes crucial that assets and liabilities not connected with a potential permanent establishment be completely separated from those assets and liabilities which are so connected.

Receipts by a foreign corporation from a U.S. person of fixed or determinable annual or periodical income, such as dividends and interest, which are *not attributable* to the foreign corporation's U.S. permanent establishment (even if the permanent establishment may physically receive the payment), are generally subject to a gross basis U.S. tax, to be withheld at source. Such income, however, will *not* be subject to the BLT.

Interest payments by a foreign taxpayer's U.S. permanent establishment will only be subject to the BLT on interest if such payments are "allocable to effectively connected income"[34] (i.e. relate to liabilities on the PE's books that are connected with the PE's U.S. business). Payments on liabilities, if any, which are not so connected will be exempt from the branch level withholding tax on interest.[35]

2. Non-discrimination provision

It would appear that the BLT on interest, unlike the BLT on profits, will not be affected by the non-discrimination provision in treaties. When addressing treaty restrictions on the applicability of the BLT, Section 884(e) of the Code refers only to the profits tax (paragraph (a) of Sec. 884), but does not refer to the withholding tax on interest (paragraph (f) of Sec. 884). In fact, the amendment imposed by subsection 884(f) is more akin to an amendment to each of Sections 871 and 881 which deal with the taxability to foreign recipients of such interest (i.e. interest paid by the PE). In addition, unlike the secondary withholding tax on dividends, which generally continues to apply whenever a treaty disallows the BLT on profits, the

domestic corporation if "under any treaty obligation of the United States the foreign corporation is entitled to non-discriminatory treatment with respect to that interest." It has been generally understood that the non-discrimination article in the Netherlands Antilles (N.A.) treaty will entitle a N.A. corporation with a U.S. real property interest to make such an election, even though the N.A. treaty contains the older version of the non-discrimination article (i.e. uses the expanded definition of "citizens or subjects" instead of the separate reference to "permanent establishment" contained in the modern treaties). It would be patently inconsistent, to say the least, to permit the older non-discrimination article to apply to corporations for purposes of Sec. 897(i), but not for purposes of the BLT. See Exhibit A for a complete list of those treaties with each type of non-discrimination provision.

28. See note 36, infra.

29. See Exhibit A for a list of such treaties. For a detailed discussion of the non-discrimination provisions in FCN treaties, see Kees van Raad, "A survey of the U.S. FCN Treaties," Tax Management International Journal (April 11, 1986).

30. FCN treaties also afford "most favored nation" protection to companies of one Party which are *not* deemed to be "engaged in trade" within the territories of the other Party. This tends to indicate that the non-discrimination provisions were meant to provide unfettered protection.

31. Act Section 1241(b) amending Sec. 861(a)(2).

32. See Exhibit A for a list of such treaties.

33. Ibid.

34. Although the Code provides that "any interest paid by such trade or business shall be treated as if it were paid by a domestic corporation," the title of the subsection limits its applicability to "interest allocable to effectively connected income."

35. The corollary to this argument is that, under Sec. 265 analogy, payments of interest on liabilities which are not connected with the PE's U.S. business will not be deductible by the U.S. PE against its effectively connected income since the income to which these liabilities relate was not subject to graduated income tax pursuant to Sec. 882(a). See Sec. 882(c)(1).

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secondary withholding tax on interest was totally eliminated by the 1986 Act. This would tend to strengthen any argument that the BLT on interest cannot be negated through the non-discrimination route. This conclusion also makes sense in that the BLT on interest is structured, for the most part, as a flat rate tax assessed on foreigners with respect to their fixed and determinable interest income, and such tax, as the only U.S. income tax on a discrete category of taxpayer, has never been deemed to be discriminatory.

Some commentators have indicated their concern that the U.S. withholding tax on the excess of the allocable interest deduction under Reg. 1.882-5 over interest actually paid by the branch *is* discriminatory, arguing that this is a tax on the U.S. permanent establishment of a foreign corporation which a U.S. corporation would not be required to bear. While this argument is technically accurate, it must be remembered that the excess interest deduction allocated to the branch can almost be regarded as an additional "bonus" deduction available to a foreign corporation with a U.S. PE which is not also available to a U.S. corporation. Therefore, the quid pro quo for this additional deduction is an additional withholding tax on a deemed payment of this excess deduction by the branch, as a hypothetical domestic corporation, to its foreign home office. Whether this rationale will be sufficient to sustain the applicability of the BLT on the notional interest deduction remains to be seen.

3. Secondary withholding prohibition

As with the secondary withholding tax on dividends, a handful of treaties also prohibit a secondary withholding tax on interest. Even though the BLT on interest is not technically a "secondary" withholding tax, it appears that the treaty prohibition may apply to the BLT on interest.

A typical treaty article prohibition against secondary withholding is Article XII of the U.S.-Netherlands treaty which provides that "dividends and interest paid by a Netherlands corporation shall be exempt from United States tax. . . ." Since the branch is not a separate juridical entity, any interest paid by the branch is, in reality, a payment by the foreign corporation itself. Therefore, this treaty prohibition seemes to apply literally. It has been suggested, however, that the treaty prohibition may not apply since the BLT statutorily recharacterizes the branch into a hypothetical domestic subsidiary corporation of the foreign taxpayer for purposes of the BLT withholding tax on interest. If the legislators meant to "skirt around" this treaty provision by creating a hypothetical domestic corporation, this should have been specifically stated in the legislative history.[36] In fact, such a position would seem to conflict with the general intent of the drafters of the BLT provisions – not to override treaties in the absence of a treaty shopping situation.[37] In our view, the treaties should prevail under these circumstances.

4. Interest "borne by" a permanent establishment

Most of our modern treaties allow a Contracting State to impose a withholding tax on interest paid by a foreign corporation if it is deemed to "arise" in that Contracting State.[38] In essence, the tax is the liability of the recipient of the interest, but the foreign corporation is responsible for collecting the tax, by withholding, if it arises in the U.S. Interest is generally considered to arise in a Contracting State, in the case of a foreign corporation with a permanent establishment in that State, if:

(1) the indebtedness on which the interest was paid is incurred "in connection with" the business activities of the PE, and
(2) the interest is "borne by" the PE.

A question exists as to whether the excess portion of an allowable interest deduction (i.e. the total deduction as calculated under Reg. Sec. 1.882-5), over the actual interest paid by the PE is considered to be "borne by" the PE. If not, the BLT on interest cannot be imposed on the excess. The Treasury Department has interpreted this term, in its Technical Explanation to several U.S. income tax treaties, as meaning "deductible by" the U.S. PE.[39] We think that this is a justifiable position, balancing the allowability of a deduction against the taxability of the income. If, on the other hand, actual interest payments exceed the allowable interest deduction U.S. withholding on the excess payment may be prohibited by treaty since such excess was not "borne by" (i.e. deductible by) the U.S. PE.

Similarly, as mentioned earlier, the BLT cannot be imposed on any interest paid with respect to any liabilities which are not "connected with" the PE, even if such liabilities may be on the PE's books. Such payments not only fail to satisfy a treaty's "in connection with" test, but they will also fail to satisfy the "borne by" test since such payments are not deductible by" the PE pursuant to Section 882(c)(1).[40]

C. Reduction or modification of branch tax

If a U.S. income tax treaty allows a BLT, but requires a different method of computation than the statutory provision, which may result in a lower BLT, the treaty provision, and not the Act, should control.[41] If a particular treaty does not specify a branch tax rate, the maximum dividend withholding rate which that treaty

36. "The courts do not favor repudiation of an earlier treaty by implication and require *clear indications* that Congress, in enacting subsequent inconsistent legislation, meant to supersede the earlier treaty." Rev. Rul. 80-201, 1980-2 C.B. 221; Rev. Rul. 80-223, 1980-2 C.B. 217.
37. See Senate Finance Committee Report on H.R. 3838, General Explanation, p. 404, "Relationship with tax treaties."
38. E.g., see Article XI(6) of the U.S.–Canada Income Tax Treaty. See Exhibit A for a list of other such treaties.
39. E.g., see Tech. Expl. to Article XI(6) of the U.S.–Canada Income Tax Treaty.
40. See note 35 and accompanying test supra.
41. E.g., see Article X(6) of the U.S.–Canada Income Tax Treaty which not only specifically permits the BLT, and specifies a 10% rate, but also seems to base the tax on "business profits" (i.e. taxable income) instead of "earnings and profits." Note also that the Canadian treaty specifically provides that prior years' deficits may offset the current year's profits, which overrides the so-called "nimble dividend" rule contained in the branch profits tax. (See note 8 and accompanying text, supra.)

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EXHIBIT A
Treaty restrictions on the application of the branch level tax

Treaty	Branch profits tax (Non-discrimination prohibition?)	Secondary withholding tax on dividends	Branch tax and interest
Aruba (1948)	C&S	Prohibited	Secondary W/H Prohibition (?)
Australia (1953)	Permits BLT (15%)	50% threshold	"Borne by"
Austria (1956)	C&S	Prohibited	Secondary W/H Prohibition (?)
Barbados (1984)	Permits BLT (5%)	Permitted	"Effectively connected" rqmt.
Belgium (1970; 1961)	PE; FCN	Prohibited	"Borne by"
Canada (1980)	Permits BLT (10%)	Permitted	"Borne by"
China (1984)	Specifically prohibits BLT; PE	Prohibited	"Borne by"
Costa Rica (1851)	FCN (?)	N/A	N/A
Cyprus (1984)	PE	50% threshold	"Effectively connected" rqmt.
Denmark (1948; 1951)	C&S; FCN	Permitted	No restrictions
Egypt (1980)	PE	50% threshold	"Borne by"
Estonia (1925)	FCN	N/A	N/A
Ethiopia (1951)	FCN	N/A	N/A
Finland (1970; 1934)	PE; FCN	80% threshold	80% threshold
France (1967; 1778)	Permits BLT (15%); FCN	80% threshold	"Borne by"
Germany, F.R. (1954; 1954)	C&S; FCN	Prohibited	Secondary W/H Prohibition (?)
Greece (1950; 1951)	C&S; FCN	Prohibited	Secondary W/H Prohibition (?)
Honduras (1927)	FCN	N/A	N/A
Hungary (1979)	PE	50% threshold	"Arising" (w/o defn)
Iceland (1975)	PE	Prohibited	"Borne by"
Iran (1955)	FCN	N/A	N/A
Ireland, Rep. (1949; 1950)	C&S; FCN	Prohibited	Secondary W/H Prohibition (?)
Israel (1951)	FCN	N/A	N/A
Italy (1955; 1948)	PE; FCN	Prohibited	"Borne by"
Jamaica (1980)	PE	Prohibited	"Borne by"
Japan (1971; 1953)	PE; FCN	Sourcing rule prohibition	"Borne by"
Korea, Rep. (1976; 1956)	PE; FCN	Sourcing rule prohibition	"Borne by"
Liberia (1938)	FCN	N/A	N/A
Luxembourg (1962; 1962)	C&S; FCN	Prohibited	Secondary W/H Prohibition (?)
Malta (1980)	PE	50% threshold	"Borne by"
Morocco (1977)	PE	Prohibition	"Borne by"
Muscat & Oman (1958)	FCN	N/A	N/A
Netherlands (1948; 1956)	PE; FCN	Prohibited	Secondary W/H Prohibition (?)
Netherlands Antilles (1948)	C&S	Prohibited	Secondary W/H Prohibition (?)
New Zealand (1982)	Permits BLT (5%)	50% threshold	"Borne by"
Nicaragua (1956)	FCN	N/A	N/A
Norway (1971; 1928)	PE; FCN	50% threshold	"Borne by"
Pakistan (1957; 1959)	C&S; FCN	Prohibited	No restrictions
Paraguay (1859)	FCN (?)	N/A	N/A
Philippines (1976)	PE	50% threshold	"Borne by"
Poland (1974)	PE	No restrictions	"Borne by"
Romania (1973)	PE	No restrictions	"Borne by"
South Africa (1946-7/1/87)	C&S (w/o defn)	No restrictions	No restrictions
Spain (1902)	FCN (?)	N/A	N/A
Sweden (1939)	C&S	No restrictions	No restrictions
Switzerland (1951)	C&S	Prohibited (non-residents only)	Secondary W/H Prohibition (?)
Taiwan (1946)	FCN	N/A	N/A
Thailand (1966)	FCN	N/A	N/A
Trinidad and Tobago (1970)	PE	50% threshold	"Paid by"
U.S.S.R. (1973)	"Representations" (equiv. to PE)	No restrictions	No restrictions
U.K. (1975)	PE	Prohibited	Secondary W/H Prohibition (?)
Vietnam (1961)	FCN	N/A	N/A
Yugoslavia (1881)	FCN (?)	N/A	N/A

Key:

Non-discrimination provisions:
PE – permanent establishment language } Income tax treaties
C&S – citizens or subjects language } Income tax treaties
FCN – treaties of friendship, commerce and navigation
Dates – represent the dates upon which the respective conventions (income tax; FCN) were signed.

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specifies as to wholly-owned corporations will be used as the rate to be applied on branch profits, and the general interest withholding rate of that treaty will be applicable to the BLT on any "deemed" interest payments to the home office. The rate relating to actual interest payments by a branch will depend on the jurisdiction in which the recipient of the interest is resident; if such jurisdiction is the U.S., no BLT would apply.

D. "Treaty shopping" provisions

Both the full rate BLT and the full statutory withholding rate on interest apply in treaty shopping situations notwithstanding any conflicting treaty provisions. Treaty shopping is deemed to exist *unless* (1) the foreign corporation enjoys the status of a "qualified resident" of the other Contracting State *or*, (2) failing qualified residence status, the income tax treaty in question permits a secondary withholding tax on dividends paid by the foreign corporation.

A foreign corporation is deemed to be a qualified resident of the other Contracting State *unless*, looking through all intervening entities, *more than 50% (in value)* of the stock of the foreign corporation is ultimately owned by individuals who are not residents of the treaty country *and* who are not citizens or residents of the U.S.[42] A corporation whose stock is regularly traded on an established securities market situated in the country where it is resident (including any subsidiaries of the listed company resident in the same country) will be treated as a qualified resident of that country.[43] Where, however, 50% or more of the foreign corporation's income is used (directly or indirectly) to meet liabilities to persons who are not residents of either the corporation's country of residence or the U.S., the corporation will still not be a qualified resident of its home country for purposes of eliminating the treaty override of the statutorily imposed BLT.[44] It is also anticipated that Treasury regulations will further except from the treaty shopping restrictions certain corporations carrying on active business operations in their home countries, even if they run afoul of the ownership limitations (provided there is no "base erosion" as discussed above).

The objective statutory treaty shopping rules may be easy to plan around, in the case of corporate joint ventures, if flexibility exists with respect to each investor's ownership percentage. For example, a Dutch corporation, more than 50% of the value of whose stock is held by a combination of Dutch and U.S. residents (or U.S. citizens) will not be subject to the BLT. Since these treaty shopping provisions are based solely on value, the voting control of a foreign corporation can be shared equally between the Dutch-U.S. interests and the third country interests. In fact, if a U.S. shareholder were to control 50% of the voting stock and the third country national the other 50%, such U.S. shareholder would also avoid Subpart F involvement, provided a nominal amount of *non-voting* stock is issued to a Dutch resident. For example, ownership of a Dutch corporation with a U.S. PE could be structured as follows:

	Voting control	Value
Third country resident	50%	49%
U.S. citizen or resident	50%	49%
Dutch resident	0%	2%

Since the total qualifying ownership (U.S. citizen/resident + Dutch resident) is over 50% in value (49% plus 2%), the BLT will not apply. In addition, since the U.S. shareholder does not own *more than 50%* (in voting control or value), Subpart F will not apply either.

It is not entirely clear, in the case of non-qualified residents, when a treaty "permits" a secondary withholding tax on dividends, so as to avoid application of the BLT despite a foreign corporation failure to meet qualified residency. For example, as discussed earlier, some treaties contain language (similar to prior law) in which secondary withholding is triggered only when U.S. effectively connected gross income of the U.S. branch, over the requisite period, equals or exceeds 50% of total gross income. This contrasts with the 25% threshold introduced in the 1986 Act. In addition, the Swiss treaty permits secondary withholding tax with respect to non-Swiss residents only, not with respect to Swiss residents, whereas the statute permits the secondary withholding with respect to any foreign person. Would such dilutions of the scope of the statutory secondary withholding tax by a treaty be cause for the IRS to conclude that such treaty did not "permit" a secondary withholding? We believe the proper answer to this question, which should be addressed in regulations, is no.

E. Elimination of tax on deferred payments and appreciated business assets

The new provision levying tax on deferred payments (which are received after termination of, but applicable to, U.S. trade or business activities) and gain realized on appreciated business assets (which are sold after removal from U.S. taxing jurisdiction) would also appear to be prohibited by most income tax treaties. Very few treaties specifically permit U.S. taxation of income and gains which were attributable to a permanent establishment, but received in a year after the permanent establishment was terminated.[45] Article VII of U.S.–Canadian Income Tax Treaty, however, does provide that business profits may be

42. Treasury representatives have also indicated that, where the foreign corporation is *not* a "qualified resident," the shareholders of such corporation, resident in another country, *may not* derive any secondary benefit (i.e. non-discrimination, secondary withholding prohibitions, reduced rates, etc.) from the tax treaty that their own country of residence may have with the U.S.

43. This exception for publicly traded companies does not appear to be available for foreign corporations whose shares are primarily traded in the U.S. or any corporation whose shares are primarily traded on exchanges in other foreign countries.

44. This provision was added by the Conferees to prevent "base erosion" (i.e. erosion of the foreign country's tax base) in conjunction with reduced treaty rates.

45. Only the U.S. treaties with Barbados and Canada specifically permit such taxation.

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taxed by a Contracting State if a resident of the other Contracting State "carries on, *or has carried on*, business" in the first-mentioned State. (Emphasis added.) Most treaties, however, do not contain such language and, accordingly, they would seem to eliminate this tax bite.

CONCLUSION

The branch tax concept, as added to the U.S. Code, presents many complexities as well as unanswered questions. In the absence of any statutory exception,[46] the tax applies unless it is reduced, modified or eliminated by treaty. (The tax on deferred payments and appreciation on business assets can also be eliminated under many income tax treaties.) Finally, the branch level tax on the branch's profits can at least be deferred as long as the branch's profits continue to be reinvested in business assets and activities.

46. Statutory exceptions are: (1) statutorily exempted (as well as treaty exempted) transportation income; (2) certain income treated as effectively connected under the Foreign Sales Corporation rules (new U.S. export incentive provisions); (3) gains on the disposition of shares or certain other interests in U.S. real property holding corporations (but gain on the disposition of a U.S. real property interest, such as the U.S. real estate itself, is not excepted); (4) Subpart F related person captive insurance income, with respect to which an election may be made to treat such income as effectively connected income; and (5) income of corporations organized in certain U.S. possessions.

Conference Diary

JANUARY 1987

British Branch of I.F.A.: Tax Aspects of Financial Instruments. London, 8 January (English).

Internationales Steuerseminar Zürich: Steuerplanung und Praxis Europa–U.S.A., St. Moritz, 12-16 January (German).

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).

Richard De Boo Conferences: Government Assistance for Canadian Business. Toronto, 26 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).

APRIL 1987

International Bureau of Fiscal Documentation: 1st East-West Tax Congress (Seminar). Salzburg (Austria), 14 and 15 April (English).

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The Freedom of a State to Legislate in Fiscal Matters under General International Law

By A.H. Qureshi*

> "Un Etat ne peut vivre librement
> que s'il peut imposer librement!"[1]

INTRODUCTION

At the frontiers of a State's fiscal domain, the forces of freedom and independence, characteristics of State sovereignty, confront the ethos of the sovereign equality and the inter-dependence of States. This conflict of forces underlies the continuing "bugaboo"[1a] on a State's legislative fiscal jurisdiction.[2]

There is a dichotomy in perception as to the International Law position with regard to the content and extent of a State's legislative fiscal jurisdiction – although the existence of fiscal jurisdiction as a function of International Law is unquestioned.[3] On the one hand, it is maintained without reserve that there are no limitations under International Law as to a State's legislative fiscal jurisdiction,[4] other than in the realm of enforcement.[5] Thus, A.A. Knechtle states:[6]

> Up to the present there has been no internationally recognized principle in public international law which limits the sovereignty of States in fiscal matters . . . in principle there are no externally imposed legal limits on the fiscal jurisdiction of States. Even where external relations are involved, national fiscal law can be shaped by the tax legislator as extensively as appears useful to him . . . modern tax legislations are not restricted in their national right to tax by any rules in the systems of public international law.

On the other hand there is the "link" or "reasonable connection" school which asserts that the legislative competence of a State in fiscal matters is limited by the requirement of a "legally relevant connection" between the State and the taxpayer. Thus, Akehurst states:[7]

> Customary international law permits a State to levy taxes only if there is a genuine connection between the State and the taxpayer (nationality, domicile, long residence, etc.) or between the State and the transaction or property, in respect of which the tax is levied.

Similarly, Mann in endorsing the 1981 Tentative Draft No. 2 of the Revised Foreign Relations Law of the United States asserts that a State can only exercise its fiscal legislative jurisdiction under International Law provided there is a reasonable relationship between the State and the taxpayer's property or transaction. The overriding requirement he asserts is "a sufficiently close legal connection to justify, or make it reasonable for, a State to exercise legislative jurisdiction".[8]

Paragraph 411 of the 1981 Tentative Draft No. 2 of the Revised Foreign Relations Law of the United States adumbrates the links that are considered as reasonable bases of legislative tax jurisdiction. It is stated:

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* I am grateful to Dr. A.V. Lowe, Dr. D. Williams and Professor Gillian M. White of the University of Manchester for their suggestions.

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(1) A State may tax a person (natural or juridical) on the basis of any of the following *links*:
   (a) nationality;
   (b) domicile;
   (c) residence, in the case of a natural person.
(2) A State may also exercise limited jurisdiction to tax persons (natural or juridical), on the basis of any of the following *links*:
   (a) presence of doing business in its territory;
   (b) ownership of property located in its territory.
(3) A State may exercise jurisdiction to tax:
   (a) property located in its territory;
   (b) transactions that occur, originate or terminate in its territory or have a substantial connection to the State. [Italics added.]

Apart from the expressly defined limited jurisdiction to tax above and the overriding requirement of reasonableness,[9] the Draft Restatement doesn't elucidate fully on the ambit of the jurisdictional net once a recognized link is established.[10] This much, however, is asserted in the commentary:

> While the issue seldom arises in disputes between States, *an unreasonable* exercise of jurisdiction to tax, for instance a tax on a non-resident alien only temporarily present within a State, measured by his world-wide income, would be a violation of international law, and could be challenged on that ground both by the taxpayer and by the State whose national is adversely affected by the tax.[11] [Italics added.]

The statement on tax jurisdiction in the Tentative Draft is based, it is asserted in the Draft, on the practice of States and bilateral agreements – although it is conceded that it is not one of international unanimity. Further, paragraph 411 is illustrative of paragraph 403 which defines a State's limitation to prescribe, with reference to the criterion of reasonableness.[12]

In this article, the issue generated by these apparently diametrically opposed perspectives on fiscal legislative jurisdiction is considered.

THE ISSUE

As a preliminary point, some clarification of the issue is required. The issue under consideration is whether there are any limits under General International Law (i.e. Customary International Law and General Principles of Law recognized by civilized nations) on a State's legislative fiscal competence.

First, the "limits" to a State's fiscal jurisdiction asserted by the "reasonable link" school purport to define the extent of jurisdiction and not the manner in which jurisdiction should be exercised. It is also these limits with reference to which a freedom is asserted by the opposing school.

Second, the assertion[12a] on the one hand, that a State's fiscal legislative competence is not regulated by any rules of General International Law distinguishes between fiscal matters which are essentially within the State's domestic jurisdiction; fiscal matters with a foreign character situated intra-territorially, e.g. foreign national within the territory; and fiscal matters totally foreign, e.g. foreign national outside the territory with no connection with the State. On the other hand, with respect to the "reasonable link" perspec-

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1. M. Chretien, *A la recherche du droit international fiscal commun*, Paris, 1955, at p. 63.
1a. D.R. Tillinghast, *Tax Aspects of International Transactions*, Part V, 1978, at p. 63.
2. A State's legislative fiscal jurisdiction relates to that aspect of a State's legislative regulatory activity in the fiscal sphere that has in some way a foreign character.
3. E.g. F. Mann, *Studies in International Law*, 1973, at p. 4.
4. A. Knechtle, *Basic Problems in International Fiscal Law*, 1979, at pp. 37 and 41. Similar assertions are found elsewhere. See e.g.: (1) League of Nations, *Taxation of Foreign and National Enterprises*, Vol. 11 at p. 13. It is stated: "When one peruses the great books on public or private international law, one finds little said about the limitations of fiscal sovereignty." – (2) H. Wurzel, "Foreign investment and extra territorial taxation." *Columbia Law Review*, 1938, Vol. XXXVIII at p. 814. It is stated: "Is there anything in the written or unwritten law of nations to indicate a universally recognised rule authoritatively assigning among nations, and thereby impliedly limiting the jurisdiction to tax? The answer is very definitely in the negative." – (3) Martin Norr, "Jurisdiction to tax and international income." *T.L.R.*, 1962, p. 431. It is stated: "No rules of international law exist to limit the extent of any country's tax jurisdiction. Similarly, no rules exist to require a country to grant relief from international double taxation." – (4) M.L. Muten "The delimitation between the country of residence and other countries of the power to tax corporations and/or their shareholders." *Cahier de droit fiscal international*, Vol. 49 b, 1964, at p.77. It is stated: "No rule of International law, whether in the form of an internationally recognised principle or in the form of international custom, implies that the principle of territoriality should be observed in respect of all kinds of taxes." – (5) See also, e.g.: (1) M. Chretien, "Existe-t-il un droit fiscal commun?" *Revue Critique de droit international privé*, 1953, p. 783. – (2) *Publications of the International Bureau of Fiscal Documentation*, Conventions – Amsterdam, 1965. Vols. 11-14. – (3) Hackworth, *Digest of International Law*, Vol. 111, 1942, p. 594.
5. S.S. "Lotus" *PCIJ*, Series A, No. 10, 1927, pp. 18-19. It is stated: ". . . the first and foremost restriction imposed by International law upon a state is that . . . it may not exercise its powers in any form in the territory of another state." See also e.g. S. Knechtle, ibid., at p. 40; Mann, op. cit., supra, 3.; and J.H. Beal, "The Jurisdiction of a Sovereign State", 1923, 36 Har. L.R., at p. 241.
6. A. Knechtle, op. cit., supra, note 4, at p. 37 and 41.
7. M. Akehurst, "Jurisdiction in International Law", *B.Y.I.L.* 1972-73, p. 179.
8. Mann, F. "The Doctrine of International Jurisdiction Revisited after Twenty Years." *Recueil des Cours*, 1984, Vol. 111, at p. 29. Similar assertions are found elsewhere, e.g.: (1) J.E. Bischel and R. Feinschriber, *Fundamentals of International Taxation*, 1977, at p. 6. It is stated: "For a country to impose a tax, the transaction or its participants must have a significant connection with the country." – (2) Hyde, *International law chiefly as interpreted and applied by the U.S.*, Vol. 1, Section 205. "It must be clear that in so far as international law is concerned the right of a state to impose a personal tax upon an individual depends upon the intimacy and closeness of the relationship that has been established between itself and him." – (3) D.P. O'Connell, *International law*, Vol. 11, at p. 717. – (4) Imperial Tobacco Co of India v. Commissioners of Income Tax, 1985, *ILR*, Vol. 27, p. 103. – (5) Albrecht, A.R. "The taxation of aliens under international law." 29 *BYIL* 1952, at p. 153 it is stated: "The power to tax is also limited by the nature of the jurisdiction".
9. Para. 403, Tentative Final Draft (15 July 1985). The American Law Institute. Restatement of the law. Vol. 2. Part IV.
10. As per A.V. Lowe, University of Manchester. 13 Jan. 1985.
11. Contrast Lord Herschell in Colquhoun v. Brookes (1889) H of L 14 APP. Cas 493, at p. 503 where he stated obiter in response to a seriously contended argument put on behalf of the respondent: "It is urged, however, on behalf of the respondent, that if this construction be adopted a foreigner residing for a short time only in this country would be subjected to taxation here in respect of the whole of his business earnings in his own country or elsewhere, that so to tax him would be opposed to international comity . . . *but I do not feel satisfied that it would involve a violation of international law. . .*" (Italics added.)
12. Op. cit., supra, note 9.
12a. Knechtle. op. cit., supra, note 4.

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tive, this distinction between fiscal affairs purely or essentially within the domestic domain and fiscal matters with a foreign complexion is not always made clear. There is a suggestion in some of the assertions that a State may tax *only* where there is a "reasonable link" in the given sense (e.g. residence, nationality), in all the circumstances, even when the reasons for the taxation and the factual elements are all essentially domestic in character. Thus, income tax based on religious beliefs on income earned within the State may constitute an unreasonable link because the activity within the State generating income (i.e. the "reasonable link") is not itself *the* basis of taxation as such, even though it is a necessary incident.

The point being asserted is that with respect to factual "scenarios" that are essentially or primarily within a State's domestic domain, the assertion of a "reasonable link" and the listing of connecting factors, even if the "reasonable link" conforms in large measure with a state of affairs that is primarily within the domestic jurisdiction, is conceptually not sound, and is tendentious. It is unsound conceptually as it suggests that International Law by way of the principle of a reasonable link has made an inroad in the domestic fiscal domain of a State; rather than affirming as it should that the "reasonable link" criterion reflects the domestic sphere because the domestic sphere as a principle of International Law is the pertinent and dominant force.

It is tendentious, because it advances in the domestic sphere of a State a particular fiscal order (characterized by a certain aura of reason, of relevance, and of objectivity), as encapsulated in the "reasonable link" idea. In the context of domestic fiscal affairs, it is not merely an exercise in mapping the boundaries of "domestic", but rather it tends towards disguised regulation of matters that are essentially within the domestic domain. By particularizing the circumstances of what constitutes domestic (e.g. residence, transaction within a State, etc.) it thereby tends towards an attempt at the regulation of domestic affairs.

In the circumstances, it will be assumed here that the assertion of a requirement of a "reasonable link" is intended only in the context of legislative activity where there is a foreign element involved – whether intra-territorial or extra-territorial.

Third, the limitations under General International Law on a State's legislative fiscal jurisdiction relate only to those regulatory forces in the legislation which are very likely to be enforced[12b] by the State.

Finally, fiscal jurisdiction is a function that is essentially wealth acquisitory rather than conduct regulatory. As such the activity is confined under International Law to the limits of a State's territory.[12c] Given this limit and this characterization of the activity the distinction between legislative and enforcement jurisdiction traditionally made in the context of other State activities is only marginally significant in fiscal matters. This is because a wealth acquisitory function articulated legislatively alone is of little consequence unless it is actually enforceable. Thus, in the context of fiscal legislative jurisdiction the question of its extra-territorial reach is in a sense "academic". In fact to the extent that it is "academic" International Law does not deliberate on it as it does not impinge on another State's sovereignty.[12b] The critical question really is how may a State implement within its territory its fiscal policy.

Formulated in this manner the issue of fiscal jurisdiction is not appropriately analyzed in the context of extra-territorial jurisdictional issues alone. For this reason, the "limitations" that are asserted will here be distinguished between those limits which affect a State's legislative fiscal jurisdiction within its territory, and those which constrain the extra-territoriality of fiscal legislative assertions.

ANALYSIS

It is the thesis of this article that the former view, that there are no constraints on a State's legislative fiscal jurisdiction under International Law, has indeed much force; and in a sense, encompasses the "reasonable connection" position. This is for the following reasons.

First, *in the context of foreign involvement within the territory,* the constraint imposed by International Law on a State's fiscal legislative jurisdiction is, it is suggested, only minimal. It is minimal in that the concern of International Law in the fiscal sphere is designed mainly to ensure the minimum standard[13] under International Law in favour of foreigners. Thus, a State may be in violation of this standard when it imposes on an *unsuspecting* transient visitor tax based on his world-wide income.

However, to draw from this minimal level of reason imposed by International Law a wider theory of legislative fiscal jurisdiction based on a reasonable connection is another matter.[13a] The assertion of the "reasonable link" is not within the ambit of the minimum standard nor in satisfaction of the minimum standard. In fact, it is more extensive. It is not merely a regulatory force within the territory, it is a regulatory force impinging on that domain of a State's important right to formulate its own foreign and economic policy that manifests itself intra-territorially vis-à-vis foreigners within the State.

Thus, the impact of the "reasonable link" requirement, in spite of adherence to the minimum standard invites a State to address itself to the question whether a foreigner (or the property of) within the territory, is a national or not, is domiciled or not, is resident or

12b. Mann, op. cit., supra, note 3, at p. 7. He states: "Moreover, the mere exercise of prescriptive jurisdiction, without any attempt at enforcement, will not normally have to pass the test of international law, for so long as a state merely introduces a legal rule without taking or threatening steps to enforce it, foreign states and their nationals are not necessarily affected."
12c. Op. cit., supra, note 5.
13. See e.g. (1) Schwarzengerger & Brown, *A Manual of International Law*, p. 84. – (2) Brownlie, *Principles of International Law*, at pp. 524-528.
13a. Thus, Brownlie ibid. states at p. 526: "A source of difficulty has been the tendency of writers and tribunals to give the international standard a too ambitious content. . ."

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not, or otherwise has a substantial connection or not, for the purposes of ascertaining whether or not it can exercise its fiscal jurisdiction, as well as for the purposes of exercising that jurisdiction in that prescribed reasonable manner.

This requirement of a "reasonable link" presupposes a world order grounded in a particular view. In allocating the fiscal burden, however, the bases of distribution are many. Nationality, domicile and residence each may be appropriate "links" for taxation in appropriate circumstances – they certainly are "relevant". They are not, however, exhaustive and they do ultimately reflect a value preference. Thus, nationality, domicile and residence are connections with a State that are relevant because by virtue of each the taxpayer may at least potentially benefit[14] in some way from the State in question. But a State may prefer to tax on some other basis. Thus, the mother countries of Ruritanian immigrants may well prefer, as an exercise of their foreign policy, to extract financial compensation from Ruritanian citizens in their territory for racial discrimination suffered in Ruritania by their nationals in the form of taxation. Or, alternatively, Ruritania may prefer to tax only cigarette smoking foreigners present, as a measure of its ideological outlook.

Further, once the foreign element arises within the territory there are no restrictions as such on the ambit or "focus"[15] of the jurisdiction so that a non-resident transient visitor may well be subject to taxation on his world-wide income, provided the minimum standard in favour of foreigners was not being violated. Thus, it is maintained here, somewhat in contrast to the stand taken in the U.S. Tentative Draft No. 2,[15a] that whilst the presence of an alien perhaps in itself may not justify tax based on his world-wide income – it may be justifiable, other considerations aside,[16] where, for example, the entry of the alien is made specifically conditional and/or reasonable advance notice has been tendered.[17] There is nothing unreasonable about this. A foreigner seeks out tax havens – and tax havens attract foreigners. In the same manner a high tax regime for foreigners that is well advertised and not set as a tax trap is equally fair game, other considerations aside.[18]

In fact, international taxation is not, on the whole, characterized by reason. Thus, there is no territorial principle in International Law which limits taxation to income arising within the territory to fiscal subjects within the "jurisdiction".[18a] Once a nexus such as residence and/or domicile is established, and in the case of some countries like the U.S.A. and the U.S.S.R., citizenship, "the right to tax extends to all the taxpayer's property wherever it may arise and irrespective of its receipt within the taxing State".[19] There is not much justification here as the nexus may not necessarily justify the scope of the taxation. For example, a multibillionaire who on the basis of, e.g., a mere six-month residence[20] (whose income is situate and earned abroad, and protected by the foreign sovereign there) is subject to taxation on his world-wide income unjustifiably, if that level of taxation does not bear, or is likely to bear, a commensurate benefit from the taxing State. There is no "reasonable link" or commensurate substantial connection here to justify such a level of extra-territorial fiscal reach once there is that initial jurisdiction. More appropriately triggered perhaps in such a circumstance is the notion of a set fee for such connections as nationality or short residence, rather than the application of a full-scale taxing regime.[20a]

Thus, the practice of international taxation is not characterized by "reason" as such, as is asserted. This lack of territorial principle, in limiting tax to income arising within the territory to fiscal subjects within the "jurisdiction", is not confined to where there is a "reasonable link" as advocated, but has a wider applicability. It applies in all cases where there is territorial jurisdiction subject only to where the minimum standard in favour of foreigners is being violated.

To conclude, there are no limits to a State's fiscal legislative jurisdiction with regard to matters within the territory, however tenuous the presence – although the manner in which that jurisdiction is to be exercised is constrained by the minimum standard in favour of foreigners.

Second, *in the context of an extra-territorial situation,* the question posed here is whether with regard to the extra-territorial element the State has competence to legislate.

Again, it is suggested, the constraint imposed by International Law is minimal. In fact it is limited only by that important norm of International Law that limits a State's enforcement powers to its territory.[21] Save from this limit, assertions of fiscal legislative jurisdiction imposing extra-territorial tax liability likely and intended to be enforced intra-territorially are not constrained by any norm of International Law. A State may legislate *whatever* in fiscal matters, provided always that actual enforcement is intra-territorial, and not violative of the minimum obligations imposed under International Law in favour of foreigners.

There is no doubt about this extra-territorial fiscal legislative assertion at least to the extent that there is a "reasonable link" with the element that is situate

14. See e.g. Kay and King, *The British Tax System,* Chapter 5 on the choices available as tax bases.
15. A.V. Lowe, "Extra-territoriality and Economic Sovereignty". *I.C.L.Q.*, Vol. 34, Oct. 85, at p. 735. The author takes the opposite view in the article.
15a. Op. cit., supra, note 9.
16. E.g. freedom of movement under International Law.
17. In a sense the U.K. Immigration Rules under which for a minimum of £ 150,000 invested in the U.K. a person may become eligible for entry as a businessman, impose such a tax.
18. Op. cit., supra, note 16.
18a. *Cahier de droit fiscal international.* Vol. 49, 1964 at p. 77: "The delimitation between the country of residence and other countries of the power to tax corporations and/or their shareholders." Also at p. 97 it is stated: "No general rules of international law define the territorial limitations of national powers of taxation with regard to corporations and shareholders."
19. Mann, F., op. cit., supra, note 3 at p. 98.
20. See e.g. S.51 of the U.K. Income and Corporation Taxes Act, 1970.
20a. Dennis J. Olmstead, International Bureau of Fiscal Documentation.
21. Op. cit., supra, note 5.

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extra-territorially. Indeed, the "reasonable link" criterion comprises of situations when extra-territorial fiscal liability may arise. Thus a national abroad is subject to the legislative fiscal jurisdiction of the State. This legislative fiscal jurisdiction is for practical purposes very wide in its ambit in so far as it includes most situations that are extra-territorial, but likely to be of concern to the State.

There is, however, a category that is excluded by the "reasonable link" – namely where there is no reasonable link (hereinafter referred to as the alien category). With regard to this alien category the position under International Law in respect to fiscal legislative jurisdiction is largely academic, as not only is it a limited category – it is also a category normally unlikely to be the concern of the State, as fiscal legislation with respect to this category is likely to be difficult to enforce even when the element becomes subsequently intra-territorial.

Nevertheless, with respect to this "alien category" legislation has two important functions. First, it serves as notice to foreigners of the consequences that could ensue if they were ever to be found to be intra-territorial. By this notice a State is able to satisfy in some way its obligation towards maintaining a minimum standard in favour of foreigners. Second, it is a means by which a State may articulate its foreign policy.

It is suggested, however tenuous the intra-territorial connection subsequently becomes with this alien category, as long as there is an intra-territorial element, the enforcement is valid *as much as* the legislation, provided always the minimum standard in favour of foreigners is not violated.

Third, the "reasonable link" theory on fiscal jurisdiction with respect to both the above limits is based primarily on the following questionable premises.

First, there is that natural lawyer's apprehension of the ghost of a lacuna in International Law.[22] This underlies the assertion as a matter of law, of some rational basis of allocation of jurisdictional competences in fiscal matters. The assertion is in fact founded on a perception of International Law as an autonomous self-perpetuating regime evolving constantly in a particular rational direction.

There is, however, no lacuna as such in International Law in the sphere of fiscal jurisdiction. International Law has allowed a measure of discretion in the fiscal sphere to the State in recognition of the need for freedom in this sphere. The need for freedom has not merely been acknowledged and identified, but stated by the International Court[22a] as an imperative. This freedom is necessary for an international society that is based on and characterized by a plurality of political colours.

The assertion that there is a lacuna implies a fundamental need for regulatory forces without which chaos would ensue. However, this is not born out by *practice;* and where there has been anarchy States have through the system of bilateral treaties resolved conflicting fiscal jurisdictional claims. In fact, well intentioned though the "reasonable link" suggestion is, it is not appropriately drafted through the system of general International Law in the fiscal sphere, which because of its detailed character and importance does not lend itself well to regulation by this means.

In addition, as has been stated, fiscal jurisdiction, unlike other spheres of legislative jurisdiction, is by its very nature an activity not primarily conduct regulatory (as are, e.g., anti-trust or criminal spheres), but rather essentially wealth acquisitory. As such different considerations apply. The "reasonable link" is not as much of an imperative. Thus, to the extent that the international order is unorganized,[23] given the nature of the activity, set against a primarily mercantile background, States are in competition with each other in order to maximize their fiscal revenues – constrained only by the aforementiond restrictions. The situation is not one of total chaos or the complete anti-thesis of reason, but rather a competitive environment where State astuteness is the order.

The second premise on which the "reasonable link" theory is founded, is that there is a practice of States which anchors fiscal legislative jurisdiction on certain common links, grounded in a reasonable connection with the taxing State, which is the basis of a norm of Customary International Law.

There is indeed discernible a practice of States to base fiscal jurisdiction on certain common "reasonable links". However, on analysis the following points may be made with regard to these links. First, conceptions of the connecting factors differ amongst States.[24] Second, in some identical factual situations the practice of using a particular connecting factor is not necessarily present.[25] Third, some of the connecting factors are not necessarily really situations of substantial or

22. See e.g. (1) Prof. Weil in "International Law Limitations on State Jurisdiction" in *Extra-territorial application of laws and responses thereto,* ed. by Prof. C.J. Olmstead, 1984, at p. 32. It is stated: "In effect nearly all the great scholars reject this philosophy, in which they see a great danger for the future of international law." – (2) Fitzmaurice, G. Rec. des Cours 11, 1957, at p. 51: ". . . the position that a State may do so as it pleases so long as it does not violate any positive rule of international law would precisely because of the comparatively unsettled or undeveloped condition of international law in many fields be unsatisfactory because it would give too free a rein to unrestricted State action. . . Therefore a criterion that made the legality of State action turn on the absence of a positive prohibition, would go a very long way to freeing States from all effective control in regard to a large number of matters. . ."

22a. I.C.J. Reports (1986) p. 108. Case concerning Military and Paramilitary Activities in and against Nicaragua. It is stated: "A prohibited intervention must accordingly be one bearing on matters in which each State is permitted, by the principle of State sovereignty, to decide freely. One of these is the choice of a political, economic, social and cultural system, and the formulation of foreign policy. Intervention is wrongful when it uses methods of coercion in regard to such choices, which must remain free ones".

23. Schwarzenberger, op. cit., supra, note 13 at p. 8, particularly para. (c).

24. For example the definition of a residence for the purposes of corporation tax varies amongst different countries. See e.g. *International Tax Planner's Manual* – 1985. Horwarth & Horwarth International CCH.

25. Thus Knechtle, op. cit., supra, note 4 at p. 66 states: "Even where the number of connecting factors is limited, national tax claims may overlap owing to the fact of two different connecting factors (e.g. residence in one country and the source in the other)".

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reasonable connections with the taxing State as such. Thus, immigrants long settled abroad and with no present or intended connections with their mother country may by reason of their nationality be liable to tax by their country of nationality. Similarly, in the case of residence which can trigger tax on world-wide income the residence may actually be only for six months.[26]

Thus, the practice of States with regard to the use of connecting factors is not uniform in all respects and flawed in important ways. Is there then agreement at least in principle that States *should* only tax on the presence of a "reasonable link".

It is suggested that there is no such consensus or opinio juris. States have in fact formulated, as Knechtle suggests,[27] either on a unilateral or bilateral basis a criterion for determining for themselves the circumstances in which they in their infinite wisdom should tax when seized of a matter within the territory with a foreign element in the fiscal sphere. The criterion is in fact similar to conflict rules as in Private International Law.[28] As such the criterion is part of the Municipal Law and must not be confused with International Law.[28a]

More importantly, although the rules serve to identify the circumstances in which the State will exercise its tax jurisdiction, this function is in fact incidental to their primary function. The primary reason for the design of the "reasonable link" is as an instrument for effective taxation. In formulating the circumstances in which a State will tax when confronted with a foreign element the State is not concerned with the question whether or not it should exercise fiscal jurisdiction – it in fact assumes that. Operating from that premise it is concerned with exercising its jurisdiction in an effective manner.

To be *effective,* it is axiomatic that legislative fiscal jurisdiction must be based on "some link, some nexus or minimum connection, between the country asserting the jurisdiction and the taxpayer".[29] This is born out by State practice; and paragraph 411 of the 1981 Tentative Draft No. 2 of the Revised Foreign Relations Law of the United States[30] reflects in large measure the methodology employed by States to make tax jurisdiction effective. The links are in fact pressure points for States to exercise their fiscal jurisdiction.[30a] States have merely identified the pressure points, they have not set out to formulate allocative rules of jurisdiction as such although that incidental function seems to be served as well.

This point is reinforced by the fact that States do not normally engage a transient visitor with the full vigour of their fiscal regime other than in minor respects (e.g. airport tax and specific taxes on goods) because of the problem of enforcement were they to do so.

The practice of States in the use of links is also born out by bilateral agreements. However, here States are involved consciously in coordinating their fiscal legislative and enforcement powers. Indeed, the very fact of entering into double taxation agreements and the necessity thereof is a manifestation of the basic freedom of a State to legislate in fiscal matters. The imperative of a State's freedom to legislate in fiscal matters, as an aspect of State sovereignty displaces any doubt[31] there may be as to whether the network of double taxation agreements "is expressive of, or exception to the rules of customary international law".[32]

No principle of International Law has as yet evolved from the multitude of double taxation agreements – although the "one time virgin soil" may well have been "ploughed and tilled" the crop would still seem to be a decade away.[33] Double taxation agreements cannot be conceived of merely as the formalization of an existing obligation under Customary International Law derived from the network of double taxation agreements or practice of States generally – since there is no obligation under International Law to enter into a double taxation agreement with other States – nor the obligation to institute a unilateral regime to avoid double taxation.

Third, there is a tendency to view the issue of fiscal legislative jurisdiction as a self-contained, homogeneous issue. In fact, as has been indicated, there are two aspects to the issue. First, there is the question of jurisdiction which arises out of the situation that is intra-territorial. Second, there is the situation which is extra-territorial.

In fact, the considerations that have led to the evolu-

26. Op. cit., supra, note 20.
27. Knechtle, op. cit., supra, note 4 at p. 62. See also Schwarzenberger, *International Law,* 3rd Edition, at p. 392 where he states: "For purposes of conflict of laws, taxation and trading with the enemy, four connecting links have proved particularly useful: presence, residence, domicile and nationality. . . In order to prove that, in the absence of treaty obligations, subjects of international law are bound to recognise any such allocation as binding, it would be necessary to show that the allocation rests either on a general practice accepted as law or on a general principle of law recognised by civilised nations". At p. 411 he concludes: "As with the recognition of the municipal law of one State by another, recognition of the connection between a State and a creation of its own law by other States may still be more a question of mutual convenience and comity rather than a matter of strict international duty".
28. Ibid.
28a. See e.g. (1) Schwarzenberger, op. cit., supra, note 13, at p. 3. – (2) Dicey & Morris, *The Conflict of Laws,* at p. 5. It is stated: "It was at one time supposed that the doctrine of comity was a sufficient basis for the Conflict of Laws, and even today references to comity are sometimes found in English judgements. But it is clear that English courts apply e.g. French law. . . in order to do justice between the parties and not from any desire to show courtesy to the French Republic," and in the 10th edition at p. 5: "Theoretically it would be possible for English courts, while opening their doors to foreigners, to apply English domestic law in all cases. – (3) *Selected Readings on Conflict of Laws,* pp. 134-138. Association of American Law Schools. – (4) K. Nagy, "Problems of the relationship between International and domestic law" in *Questions of International Law.* Edited by G. Harasjti.
29. M. Norr, "Jurisdiction to tax and international income." *TLR* 1962 at p. 432 and Knechtle, op. cit., supra, note 4 at pp. 18-19.
30. See above.
30a. Further, the links commonly adumbrated are not exhaustive – there may well exist other pressure points that may be invoked, e.g. Tax presence Clark (Inspect. of Taxes) v. Oceana Contractors Inc. (1983) A.C. 130.
31. Op. cit., supra, note 3 at p. 95.
32. Ibid.
33. H. Wurzel, "Foreign investment and extra-territorial taxation", *Columbia Law Review,* 1938, XXXVIII, at p. 815. See also op. cit., supra, note 3 at p. 4 and Knechtle, supra, note 4 at p. 147.

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tion of the "reasonable link" theory in the context of other jurisdictional spheres such as anti-trust legislation, which have been considered primarily in the extra-territorial context because of a tendency of those spheres towards that direction, are not appropriate vis-à-vis questions of fiscal jurisdiction, which are primarily intra-territorial. Thus, almost always, fiscal legislation is linked to a State's ability to enforce and therefor there is some substantial connection with the State.

Finally, the blue-print of the "reasonable link" is entrenched in the anti-Lotus stand. This anti-Lotus stand is critical of the statement in the Lotus case,[34] affirming the plenary competence of a State subject only to prohibitions under International Law.[35] Thus, A.V. Lowe states:[36]

> Arguments in favour of a presumption of a legality for extra-territorial legislative jurisdiction have been so widely and heavily criticised on grounds of legal principle and logic that it would be difficult to rest any claim upon the presumption alone.

Although it is not intended here to enter into a detailed appraisal of the nature of State sovereignty, the following brief comments nevertheless need to be made in connection with this anti-Lotus premise. First, and without prejudice to the point being asserted here, it must be noted at the outset that the arguments being asserted in this article are not based solely on the Lotus presumption.[37]

Second, preoccupation with the Lotus presumption has the effect of blurring the divide between legislative jurisdiction concerned with an extra-territorial claim and legislative jurisdiction concerned with an intra-territorial stituation. The importance of this distinction has already been pointed out, but in the context of the Lotus case, with regard to the intra-territorial situation the following needs to be noted. First, the Lotus presumption is considered at least by some critics of the case itself as having some force[38] with regard to matters which do not normally have an international aspect. Second, there is indeed a very significant school of thought which affirms the presumption in respect of intra-territorial matters. Thus, Ingrid Delupis states:[39]

> There is a presumption in favour of the full sovereignty of a State over its territory unless a title or a rule can be shown under which International law would restrict the sovereignty.

This presumption has not been effectively rebutted by the reasonable link school with regard to intra-territorial matters.

Third, the Lotus case is criticized really not because it is legally unsound but rather, underlying the criticism and triggering the criticism is concern of the implications which are seen to ensue from such a presumption.[40] Further, entrenched in the view is a philosophical stand point as to the nature of International Law and the State.[41]

Thus, couched as legal reasons are often moral concerns. For example, A.V. Lowe[42] points to the difficulty in establishing a prohibitory rule under General International Law as the defect in the logic and principle of the Lotus presumption. It is suggested, this is not so much an argument based on logic and principle itself, but rather an argument which essentially articulates the inherent constraint in the system of General International Law in establishing prohibitory rules.

Fourth, and related, opponents of the Lotus presumption generally fail to acknowledge that there is in fact a different view and that the point that is being advanced is in fact a predilection of theirs. Thus, there is no difficulty in resting a claim on the presumption as a starting premise. At best, which is not necessarily admitted, the position may be as summarized by Professor R. Higgins. She states:[43]

> . . . the underlying problem that it raises [i.e. the Lotus dictum] is still unresolved – namely is it necessary to show a specific basis of jurisdiction, or may one assert jurisdiction without reference to a specific basis, so long as one is acting reasonably.

Finally, and sadly there is a certain lack of objectivity in the reference to the jurists critical of the Lotus case. Thus no mention is made of the view of jurists from the socialist countries nor indeed from Third World countries who are not critical of the Lotus presump-

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34. S.S. "Lotus" *PCIJ,* Series A, No. 1927, pp. 18-19.
35. *PCIJ,* Series A, No. 10 (1927). The majority of the court stated at p. 19: "Far from laying down a general prohibition to the effect that states may not extend the application of their laws and the jurisdiction of their courts to persons, property and acts outside their territory, it leaves them in this respect a wide measure of discretion which is only limited in certain cases by prohibitive rules; as regards other cases, every state remains free to adopt the principles which it regards as best and most suitable."
36. *German Year Book of International Law,* Vol. 27, 1984, at p. 56. See also (1) A.V. Lowe, *A.J.I.L.* 1981, Vol. 75 at p. 263 – (2) Mann, op. cit., supra, note 3 at p. 26, – (3) Prof. Prosper Weil, op. cit., supra, note 22.
37. See above.
38. See e.g. Sir H. Waldock, "General course on Public International Law", Rec. des Cours, 1962 (11) at p. 168 where he states: "The Lotus and the Fisheries cases seem to indicate that the presumption comes into play only in regard to matters which do not normally have an 'international aspect'. . ."
39. I. Delupis, *International Law and the Independent State,* at p. 23. See also (1) Schwarzenberger, *International Law,* 3rd Edition, Vol. 1. At p. 116 he states: "So long as international law does not impose any limitations on the exercise of sovereign rights, such matters are within the exclusive jurisdiction of sovereign States". and at p. 119 he states: "The principle of sovereignty is buttressed by strong presumptions in its favour. . . In the Lotus case (1927), the World court summed up the position in still more categorical language: 'Restrictions upon the independence of States cannot be presumed." – (2) Crawford, *The Creation of States in International Law,* at p. 32. – (3) Fisheries Case ICJ Pleadings Vol. 11, 1951. See Reply of U.K. at p. 461 where it is stated: ". . . it is clear that the presumption against restrictions on independence can only operate within the areas of State activity left in principle by international law to the discretion of the State. Thus, if State A has taken action within the sphere of its domestic jurisdiction under general international law either by means of restricting the activities of foreigners in its territory or by means of a judgement delivered by its courts in proceedings brought against a party (or a ship) which is present in its territory, and State B complains that the action violates a treaty or some exceptional rule of international law regarding the exercise of judicial jurisdiction, no doubt the maxim that restrictions on sovereignty are not presumed is applicable".
40. Op. cit., supra, note 22.
41. Ibid. See also e.g. Brierly, *The Basis of Obligations in International Law.*
42. *A.J.I.L.,* 1981, Vol. 75 at p. 263.
43. Olmstead (ed.), *Extra-Territorial Application of Laws and Responses Thereto,* at p. 14.

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tion[44] – at least certainly in so far as it relates to intra-territorial matters. If the Lotus presumption is to be appraised by the views of jurists alone – Article 38(1)(d) of the Statute of the I.C.J. calls for the views of the "most highly qualified publicists of the various nations" to be considered.[45] There would seem to be here an unfortunate tendency to interpret "publicists of various nations" somewhat too narrowly!

It is suggested that, although arguments based on the anti-presumption premise are laudable as an exercise in reason, and commendable when additionally with legal content – the anti-presumption premise itself as a sole response to arguments based on the presumption cannot be seriously contended either. The scale of views, upon which too undue a premium is being placed, is not as favourably balanced as it is claimed.

CONCLUSION

The assertion maintained here that a State's fiscal legislative jurisdiction is relatively free of limitations under International Law is the assertion of an important point. First and foremost, it serves to affirm the freedom of a State to legislate in fiscal matters. Second, it highlights the dangers of a value preference regime however minimal, encroaching *(surreptitiously)* upon a State's fiscal legislative jurisdiction. Finally, the contention is conducive to the proper evolution of International Law. The enforcement limitation in International Law is in fact the prime regulator of the exercise by a State of its freedom in fiscal legislation. Considered in this light, double taxation agreements do not carry the seeds for future norms of Customary International Law inhibiting a State's basic freedom in fiscal affairs. Rather they are expressive of it.

To conclude, our task as international lawyers is to interpret International Law so as to elucidate rights, entitlements, freedoms – our task as politicians, moral theorists, visionaries is to interpret it reasonably. By evoking "obligations" and "duties" as a starting premise in interpreting International Law – the shift and the slip to the moral plane is unfortunate. The basic premise is "entitlement" because it is less of a moral premise. Pre-occupation with duties and obligations is of necessity morally more heavily laden than entitlements and rights because the former involve the inclusion of a greater variety of considerations and value preferences.

The assertion in this article that fiscal legislative jurisdiction is constrained only by the minimum standard in favour of foreigners (and the rule against extra-territorial enforcement) rather than by the requirement of a "reasonable link" may in the end in practical terms not amount to too diverging a position. It is nevertheless fundamentally and conceptually a distinct and important stand point. This is for the following reasons.

First, it does not deny or limit jurisdiction or sovereignty, nor does it purport to allocate jurisdictional competences, but rather it deliberates on the manner of the exercise of the jurisdiction. Second, it orientates the issue in the intra-territorial context thereby placing a strong presumption in favour of State action. Third, given this approach the constraint is in fact minimal.

Thus, the entitlement of a State to legislate in fiscal matters is wide. The "limitations" commonly imputed are in fact not in the context of allocating spheres of fiscal legislative jurisdiction amongst States consonant with the notion of sovereign equality of States – but rather as standards of conduct in a State's fiscal legislative affairs in the guise of jurisdictional allocation. As such they offend the notion of State sovereignty. They cannot be interpreted otherwise, since the allocation of fiscal legislative jurisdiction amongst States is already effectively regulated by the limitations under International Law of a State's enforcement jurisdiction.

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44. See e.g. (1) Tunkin, G.I., *Theory of International Law,* Chapters 8 and 9. – (2) Gazybowski, *Soviet Public International Law,* pp. 32-51. – (3) Chakst, Soviet concepts of State, International Law and Sovereignty "43 *A.J.I.L.* (1949) 31 in particular pp. 30-36. – (4) Cohen & Chiu, *People's China and International Law* at p. 106. – (3) R.St.J. Macdonald/D.M./Johnston (Editors), *The Structure and Process of International Law,* "The Third World and International Law," by Wang Tieya, at p. 968. See also op. cit., supra, note 39.

45. Thus, Mann, op. cit., supra, note 3 at p. 26 cites as "the majority of the immense number of writers" who have condemned the Lotus presumption as "Bourquin, Brierly, Rousseau, Basdevant, Fitzmaurice, Lauterpact and Waldock. Similarly, Prof. Prosper Weil, op. cit., supra, note 22 states: "In effect nearly all the great scholars reject this philosophy. . . The prevailing view – from Bourquin and Basdevant to Brierly, from Sir G. Fitzmaurice to Rousseau – is that State jurisdiction is not limited. . ." This is in fact a short list confined to some French and English jurists – and includes amazingly Basdevant who in fact represented France in the Lotus case. Further the description of the critics is somewhat emotive and does not do credit to the authors nor to their case.

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The Nature of VAT

By J.C. Holland F.C.A., A.T.I.I.

PURPOSE

1. The purpose of this article is to demonstrate, beyond reasonable doubt, that, despite its name, the consumer tax adopted throughout the EEC is not a value added tax and, because of this mistake, the economic resources of the Member States and other countries which have followed the EEC example are being wasted on a massive scale. It will show how this wastage may be prevented with relative ease, retaining the positive benefits of the tax and conforming with the principles of EEC Directives.

2. The illustrations which follow are based upon two rates, 10% and zero. The use of the zero rate for certain types of transaction is more widespread in the United Kingdom than elsewhere and reference may at times be made to the U.K. use of this rate which might not apply elsewhere in the EEC. This will not affect the principles on which the argument is based.

3. In order to avoid confusion the term "value added tax" will be used throughout to refer to the theoretical concept, "VAT" being used to distinguish the form of consumer tax adopted by the EEC.

THE PRINCIPLES OF A VALUE ADDED TAX SET OUT IN THE FIRST DIRECTIVE

4. The principles under which VAT operates are set out in Art. 2 of the First Directive. It reads:

> The principles of a common system of value added tax involves the application to goods and services of a general tax on consumption exactly proportional to the price of the goods and services, whatever the number of transactions which take place in the production and distribution process before the stage at which the tax is charged.
>
> On each transaction, value added tax, calculated on the price of the goods or services at the rate applicable to such goods or services, shall be chargeable after deduction of the amount of value added tax borne directly by the various cost components.
>
> The common system of value added tax shall be applied up to and including the retail stage.

ILLUSTRATIONS OF THE VALUE ADDED TAX THEORY IN THE FIRST DIRECTIVE

5. Illustrations of the way VAT works in practice conform with Art. 2. They show the VAT yield being collected in stages and at each stage the tax remitted is arrived at by deducting the tax borne by what are supposed to be the various cost components (input tax) from the tax received on the sale (output tax).

6. Such an illustration was contained in the 1971 Green Paper which preceded the introduction of VAT in the United Kingdom. A similar illustration is reproduced as Table 1. The accompanying explanation was as follows:

> To illustrate this let us take the hypothetical example of an article, costing £ 18 retail before tax, on which the rate of VAT is 10% of the tax exclusive price. The VAT, which the consumer would pay would be £ 1.80p, giving a total retail price of £ 19.80p. The £ 1.80p tax would have been collected in a series of fractional payments.

7. This explanation was reinforced elsewhere in the Green Paper. In paragraph 2.1, for example, VAT is compared with purchase tax, the consumer tax which it replaced in the U.K.

> VAT is a form of turnover or sales tax. Like purchase tax and some other forms of turnover tax, VAT is a tax on final consumer expenditure in the domestic economy. But unlike purchase tax, which is collected at a single stage in the production and distribution chain, VAT is collected in instalments: liability arises at each stage in the chain, whenever taxable transactions are carried out by taxable persons.

8. The explanation continues in para. 2.2.

> The VAT system described in this Green Paper is that known as the "invoice" (or "tax from tax") system. The reason for the latter term is that tax invoiced to a taxable person is deducted from tax invoiced by him to arrive at his net tax liability. This is the system prescribed in the E.E.C. Directives on value added tax. All the countries which have introduced VAT have adopted this form of the tax.

9. The nature of the tax described above is quite clear. It is a tax collected at every stage in the importation, production, distribution and retailing of goods and services. It also bears a direct relationship to the value added by each business at each of the stages as shown in Table 1. It is not, however, a tax on consumer expenditure but a tax paid by all registered businesses measured on the difference between outputs and inputs. It is not a form of indirect taxation, nor is it "the system prescribed in the EEC Directives on value added tax."

THE CREATION OF A SINGLE STAGE SALES TAX BY THE SECOND DIRECTIVE

10. VAT came into being in the EEC through the provisions of the Second Directive which was intended to bring the value added tax theory contained in the First Directive into practical effect.

11. A consumer tax was to be created by charging that tax on all transactions but allowing registered persons to reclaim all tax charged to them. In this manner the tax would only effectively be paid by final consumers who would not be registered and would, therefore, be unable to reclaim.

12. Article 11 of the Second Directive contained the appropriate provisions, giving all registered persons

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the right to reclaim all tax charged to them, subject to restrictions in respect of exempt and non-business transactions. Most importantly the right to reclaim was granted under paragraph 3 "from the tax on value added due for the period in the course of which the deductible tax is invoiced."

13. It is astonishing that it was not appreciated that the form of tax created by the Second Directive was completely different from that described in the First Directive.

14. Let us examine closely the requirements of the tax specified in the First Directive and in particular the wording of the second paragraph of Art. 2. It states that the tax "shall be chargeable" in relation to the transactions of the business. This is a very odd phrase to use in connection with a tax which that business is not intended to bear. VAT is a tax on non-business expenditure charged on the final consumer. The tax cannot possibly be charged in relation to both business activity and private consumption. The yield must relate directly to either one or the other.

15. However, if one assumes that it was intended that the tax was to be collected from businesses in relation to their transactions, not charged on them, an interpretation wholly consistent with the Second Directive, problems still remain. What the Second Directive does not do is to provide for the tax to be charged (or collected) "after deduction of the amount of value added tax borne directly by the various cost components." This omission changes the character of the tax completely.

16. The mistake was made of believing that the deduction from tax charged on invoiced sales of tax charged on invoiced purchases was the same as deducting tax "borne by the various cost components." This phrase, as does the illustration in Table 1, assumes an identity between sales and purchases which is rarely, if ever, present. The Producer in the illustration would not import raw materials, process them and then, in the same accounting period, sell them in the same quantity. Only in these circumstances can such illustrations of the manner in which the tax yield is collected be valid. They assume that the Producer and the Manufacturer never have stocks of raw materials or other goods purchased in the course of their business activities nor can they ever have stocks of finished goods or work in progress. Similar assumptions are made in respect of the Retailer. In his case the character of the goods does not change between purchase and sale, but the types of goods purchased and sold in any period will almost certainly be different. Similarly, all businesses will incur expenditure on overheads, the tax on which will be claimed in one period, but the benefit from which will be partially received in one or more other periods. As for capital expenditure, this forms a cost component for a number of years, not merely the period in which it is incurred.

17. It might be considered that, even though the direct relationship between output tax and input tax envisaged in the First Directive can be seen not to exist, nevertheless, the deduction of tax on expenditure in any period from the tax charged on sales in that period would result in a multi-stage collection as illustrated in Table 1. This possibility was destroyed by ensuring that VAT was neutral in its effects upon business costs by granting the purchaser the right to reclaim the tax charged to him on his purchase of goods and services on the same date that the supplier was obliged to account for that tax.

TABLE 1

The theoretical manner in which the VAT yield is collected from businesses in accordance with Article 2 of the First Directive

Stage	Tax exclusive price	Tax	Tax remitted	Commentary
	£	£	£	
1. Producer (P) imports materials having a value of	1.00	0.10	0.10	P pays £ 0.10 tax at importation.
2. P makes an intermediate product and sells it to a Manufacturer (M) for	4.00	0.40	0.30	P is accountable for £ 0.40 tax, but takes credit for £ 0.10 tax paid at importation. He invoices £ 0.40 tax to his customer (M).
3. M makes a final article and sells it to Retailer (R) for	9.00	0.90	0.50	M is accountable for £ 0.90 tax but takes credit for £ 0.40 tax invoiced to him by P. He invoices £ 0.90 tax to R.
4. R sells article to consumer for	18.00	1.80	0.90	R is accountable for £ 1.80 tax but takes credit for £ 0.90 tax invoiced to him by M.
Total paid by final consumer	18.00	plus	1.80	

18. The result of this on the collection process is as shown in Table 2. The common identity between tax on sales and tax on purchases on which the multi-stage collection relies has been replaced by a system under which there is an inevitable common identity between the time when the output tax is remitted by the supplier and when it is reclaimed by the purchaser. If the accounting period is a monthly one then it is obvious that no matter how many transactions there are between registered persons in the process of making any product or producing any service none of them can result in the collection of any part of the yield in advance of the sale to the final consumer. Even if the accounting period is longer than one month there will not be any advance receipt of the yield prior to the final sale since the possibility of the tax reclaim preceding the submission of the VAT will always be the same as the possibility of the VAT being collected before it is reclaimed.

19. The tax created by the Second Directive is not a value added tax. The remittance bears no relationship to the value added in the process of producing goods

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TABLE 2

The practical manner in which the VAT yield is collected from businesses in accordance with Article 11 of the Second Directive

Stage	Tax exclusive price	Tax	Tax remitted	Commentary
	£	£	£	
1. Producer (P) imports materials having a value of	1.00	0.10	0.10	P pays £ 0.10 tax at importation.
			– 0.10	P reclaims £ 0.10 tax at importation.
2. P makes an intermediate product and sells it to a Manufacturer (M) for	4.00	0.40	0.40	P is accountable for £ 0.40 tax on sale to M.
			– 0.40	M reclaims £ 0.40 tax on purchase from P.
3. M makes a final article and sells it to Retailer (R) for	9.00	0.90	0.90	M is accountable for £ 0.90 tax on sale to R.
			– 0.90	R reclaims £ 0.90 tax on purchase from M.
4. R sells article to consumer for	18.00	1.80	1.80	R is accountable for £ 1.80 tax on sale to consumer. The consumer is unable to reclaim and the yield is collected.

or services in an accounting period, it merely reflects the difference between output tax on sales and input tax on expenditure in that period. There is no multi-stage collection of the yield. At each stage prior to the final one where goods or services are sold to a consumer not registered to reclaim the tax the VAT remitted through the output tax of one registered person is cancelled out by that claimed in the input tax return of his supplier. The tax created by the Second Directive is a single stage tax, best described, possibly, as a Selective Sales Tax since the payment and reclaim of the tax between registered persons ensure that is borne only on final consumer expenditure and does not enter into business costs.

20. Before considering other aspects of VAT it should be noted that, contrary to current economic theory, a value added tax can never be a form of indirect or consumer taxation. Value added can only be determined by reference to business performance and the tax can only be paid in relation to that performance directly by the business concerned. Any attempt, such as was made by the Second Directive, to remove the impact of the tax from the business to the final consumer can only result, as has been illustrated, by the business tax remittance failing to conform to value added tax principles.

OTHER UNRECOGNIZED CHARACTERISTICS OF VAT

21. Before proceeding to estimate the cost to EEC Member States of the confusion between the multi-stage tax proposed in the First Directive and the single stage tax brought into being in the Second Directive it is necessary to clarify a number of popular misconceptions about VAT.

22. The first of these is the function of the remittances received from registered businesses. It was believed that the charging of the tax on all transactions would produce collection in stages resulting in the yield accumulating with the progression to the final stage. In fact, the reverse is true. As will be seen by Table 1 the whole of the VAT charged to the final consumer is included in the output tax return of the retailer. If the retailer had no expenditure on which he had paid VAT during any accounting period he would have no input tax to deduct. The VAT received on all his sales would be remitted in its entirety. Any input tax which he does deduct, thus determining the amount he remits, is mirrored by identical amounts in the output tax return of his suppliers. In other words the requirement for tax to be paid on all transactions and reclaimed only by registered persons is transferring a portion of the VAT which could otherwise be collected at the retail stage to the output tax returns of the retailers' suppliers for collection.

23. Of course the movement of the tax yield from the retail stage for re-collection does not stop at this point. The retailers' suppliers also have suppliers, they too have suppliers, and so on. On each transaction between registered persons the payment of VAT charged on goods and services purchased is reducing the amount of the final consumer yield received by that business for transmission to the Government and placing it in the hands of its suppliers for collection from them. If the amount of input tax paid exceeds the amount of output tax received then the surplus is repaid by the Government from remittances of tax which it has received directly or indirectly from the retail stage from remittances from other registered persons. By this means the yield from sales to final consumers is dispersed by the payment and reclaim system over all registered persons for collection.

24. The failure to appreciate that the VAT yield is dispersed from the point of final sale rather than accruing towards it has led to a misconception concerning the amount of the VAT yield at risk in relation to business transactions. The illustration in Table 1 gives rise to the belief that the tax remitted consists of VAT on sales less VAT on the cost components of those sales. Under such circumstances the amount of tax at risk from the transactions of any business would be restricted to the value added, any reduction in sales being matched by a corresponding reduction in their cost components. But this is not what happens in practice. The cost components of sales cannot be identified individually and, therefore, input tax cannot be reduced to conform with any reduction in output tax on sales. It is also contrary to human nature for a dishonest trader who wishes to evade tax on part of his sales to make any reduction in the input tax which he claims.

25. These points are illustrated in Table 3. In the interest of simplification it is assumed that the accounting period shown is of one month.

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TABLE 3

	£	VAT £	Commentary
A. All of output sold to Retailers under existing VAT system			
Sales to retailers	50,000	5,000	VAT output tax cancelled out by input tax claims of retailers.
Taxable Expenditure	30,000	3,000	Input tax claim cancelling out the output tax remitted by suppliers.
VAT remittance		2,000	No contribution to the yield.
B. Part of output sold to final consumer under existing VAT system			
Works shop sales	5,000	500	Direct contribution to yield since purchasers unable to reclaim VAT.
Sales to retailers	50,000	5,000	As in 3A above.
Taxable Expenditure	30,000	3,000	As in 3A above
VAT remittance		2,500	Only contribution to yield is the £ 500 VAT received from final consumers.
C. As in B above but assuming no payment of tax on transactions between registered persons			
Works shop sales	5,000	500	As in 3B above.
Sales to retailers	50,000		No VAT charged, none to be reclaimed.
Taxable Expenditure	30,000		No reclaim since no VAT charged.
VAT remittance consumers.		500	VAT received from final consumers.

26. First it should be noted in 3A that the remittance of £ 2,000 for the period makes no contribution to the yield. The £ 5,000 VAT charged on sales to retailers is cancelled out by the input tax claims of those retailers. The £ 3,000 claimed on VAT charged by suppliers is cancelled out by corresponding entries in their output tax returns, removing £ 3,000 accounted for by the retailers to the Manufacturer's suppliers for collection.

27. Secondly, in Table 3A consider what the position would be if the Manufacturer, deliberately or accidentally, omitted from his sales records an invoice for £ 1,000 bearing VAT of £ 100. Under these circumstances his output tax return would be reduced to £ 4,900 but, since all VAT paid on expenditure would be included in the input tax return as before, the remittance would be £ 1,900, a reduction of the whole amount of tax on the omitted invoice.

28. Finally, Table 3B illustrates the basic fact that the VAT yield is derived not from the total volume of transactions of a business but only from one type of transaction, the sale to a non-registered consumer who is unable to reclaim the tax charged.

29. In 3B an additional element to the illustration in 3A is introduced. It is assumed that the Manufacturer has a room in the factory from which sales are made to the public. For the sake of simplicity it is also assumed that, in this period, the goods sold in this shop were made from materials in stock at the beginning of the period so that there is no effect upon the amount of input tax claimed. It will be noted that the remittance increases by the VAT charged on the shop sales, once again emphasizing the lack of any relationship between the output tax and input tax returns of a business. It will also be appreciated that the additional £ 500 remitted in these circumstances is of a different character from the remaining £ 2,000. The tax has been charged to non-registered consumers. There will be no corresponding reclaim. The yield can only come from this type of transaction irrespective of the nature of the business making it.

THE COST OF THE DISCREPANCIES BETWEEN THE FIRST AND SECOND DIRECTIVES

30. Whether VAT is a multi-stage value added tax proposed by the First Directive or a single stage selective sales tax as effected by the Second Directive is of more than academic importance. The mistake has had a profound effect upon the economies of all EEC countries and others which have adopted it as a form of consumer tax.

31. The basic reason for this effect is the unnecessary administrative burden placed upon businesses by requiring them to pay VAT on their transactions with each other solely for the pleasure of reclaiming it. In Tables 1 and 2 three businesses are involved in making a total of seven returns when only the output tax return of the retailer and a single remittance by him is necessary for the whole of the yield to be received. In Table 3C it will be seen that the Manufacturer need only return and remit the £ 500 charged on his final consumer sales for that part of the yield from VAT produced by his economic activity to be effectively collected.

32. In the United Kingdom during the year to 31 March 1984 the yield of £ 14,953.8 million was collected by requiring businesses to make output tax returns totalling £ 55,645.0 million and input tax returns totalling £ 40,691.2 million.[1] In monetary terms, therefore, the work which the business community was required to do to produce the yield was almost six and a half times greater than would have been necessary if no tax had been paid on transactions between registered businesses.

33. The need to record and return amounts of VAT which have no relevance to the collection of the yield is an unnecessary burden on industry and commerce. At least 80% of this burden could be relieved. An estimate[2] of compliance costs for the year to 5 April 1981 in the U.K. put the cost of this work at £ 540 million a year. Taking inflation into account, at 31 March 1985, the last year for which figures are available, an equivalent figure would be in the region of £ 650 million of which approximate minimum savings could be made of 80%, i.e. £ 520 million.

34. Of course business VAT records must be checked

1. 75th Report of the Commissioners of Her Majesty's Customs and Excise for the year to 31 March 1984.
2. "The costs (and benefits) of collecting VAT" by Cedric Sandford, *Financial Times*, 17 February 1981.

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by the collecting authority. The fewer records which are required to be kept the fewer there are to check. It could not be anticipated that the cost of checking the accuracy of returns would reduce proportionately to the reduction in records, but it would be surprising if a revision in VAT did not provide a 50% saving in administration for all EEC countries. The cost of VAT administration in the U.K. in the year to 31 March 1985 was £ 191.3 million[3] of which half was wasted.

35. The point has previously been made that the tax at risk on every transaction is the whole of the VAT charged, not part of it. Since the payment of VAT on transactions between registered persons, in the U.K. in 1984, resulted in the necessity to collect a total of £ 55,465.0 from output tax returns to produce a yield of £ 14,953.8 million it is reasonable to assume that, in this manner, the tax at risk in producing that yield is some 3.7 times more than is necessary.

36. The difficulty in quantifying this in monetary terms is that estimates of tax lost through fraud and evasion may only be based upon offences which have been detected. In the U.K. two surveys have been made, one after the first year in which VAT operated when Customs and Excise informed the Public Accounts Committee that, in a year when the yield was £ 1,470 million, they estimated that they had failed to collect £ 35 to £ 40 million. An estimate made two years later when the yield was £ 3,769 million put the annual shortfall at £ 103 million. The two estimates were 2.5% and 2.7% respectively of the yield. With a total yield in 1985 of £ 18,535 million a comparable figure of output tax not collected would be in the region of £ 460 million. Assuming that the proportion of tax lost on transactions between registered traders is the same as that on sales to final consumers then some £ 335 million could have been saved by charging VAT only on final consumer transactions.

37. There is, however, another type of fraud, the false input tax claim. This is by far the most spectacular form of VAT fraud involving, at times, large sums of money. It was reported[4] that in the U.K. gold frauds alone had been detected amounting to £ 54 million. The elimination of the payment of VAT on transactions between registered traders would also eliminate this type of fraud, saving, it is estimated, a further £ 25 million a year in the U.K.

38. The mistake which was made has therefore been an expensive one. Its approximate effect on the U.K. economy based upon the best evidence available is summarized in Table 4. The effect on all other countries which have adopted VAT as their consumer tax must be similar.

TABLE 4

The estimated cost of the discrepancies between the First and Second EEC Directives in the United Kingdom

A. Government costs		£ million	% age of yield
Paragraphs			
35 & 36	Output tax fraud and evasion	335	1.81
37	False input tax claims	25	0.13
34	Administration	95	0.51
		455	2.45
B. Business compliance costs			
31 to 33	Unnecessary records	520	2.81
Total estimated cost to the U.K. economy		975	5.26

Notes

(i) No account has been taken above of the following:
(a) Initial cost of implementation of zero-rating transactions between registered persons (paragraph 46).
(b) Additional scope for fraud and evasion (paragraph 47).

(ii) The percentage figures above are based on the U.K. yield from VAT in the year to 31 March 1985 of £ 18,535 million.

CORRECTING THE DISCREPANCIES BETWEEN THE FIRST AND SECOND DIRECTIVES

39. VAT is charged on all transactions solely in order to try to produce a collection of the yield in stages in accordance with the First Directive. There is no justification for continuing to do so once it is appreciated that this process is merely complicating the collection of what is a single stage tax at considerable expense to both the public and private sector. The only source of difficulty is in choosing the most efficient means of achieving a change in the manner in which the tax is administered which is both in accordance with, and causes minimum change to, existing legislation.

40. The first of these requirements is catered for by Art. 27(1) of the Sixth Directive. It states:

> The Council, acting unanimously on a proposal from the Commission, may authorize any Member State to introduce special measures for derogation from the provisions of this Directive, in order to simplify the procedure for charging the tax or to prevent certain types of tax evasion or avoidance. Measures intended to simplify the procedure for charging the tax, except to a negligible extent, may not affect the amount of tax due at the final consumption stage.

41. It will by now be appreciated that if there were no VAT charged on transactions between registered businesses the possibility of evasion or avoidance of tax on these transactions would be eliminated and the administration of the tax simplified. The requirements of Art. 27 would be met.

42. The means by which the necessary change in administration could be brought about with minimal difficulty already exists and is in use, that is the concept of a positive VAT rate of 0%. This must be distinguished from exempt supplies of goods and services which are also free of VAT charge. The latter does not confer the right to deduct input tax charged in the process of making such supplies. A zero rate, on the other hand, permits the business to deduct input tax in full in the same way as for standard rated supplies.

3. 76th Report of the Commissioners of Her Majesty's Customs and Excise for the year to 31 March 1985.
4. Ibid.

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43. Previously VAT has been described as a selective sales tax. This wording was chosen because the charging of tax on all transactions and the reclaim by registered businesses ensured that the ultimate consumer was selected as the person who paid the tax. Similarly the concept of zero rating ensures that, in turn, certain ultimate consumer transactions may, for economic or social reasons, be relieved of tax without the seller of the goods or services involved being restricted in his ability to reclaim input tax. An extension of the accepted practice of zero rating to transactions between registered businesses would remove all the unnecessary costs of VAT administration set out in Table 4 while retaining all the existing virtues of the tax.

44. A full explanation of the way in which the zero rating of business transactions could best be achieved is beyond the scope of this article. The detailed means for doing this which are suitable for the U.K. would need to be adapted for other countries in relation to their current administration in order to minimize the work involved in and the cost of effecting the transition. A number of basic considerations apply however.

(1) Businesses making retail sales cannot be expected to determine whether or not their customers are VAT registered. For this reason VAT must continue to be charged on all cash sales and the tax reclaimed on them as at present by registered persons. The distinction between cash sales and credit sales would cause little inconvenience in practice since separate accounting records are kept for each.
(2) The simplest system for businesses would be for them to restrict their credit sales to those made to other registered persons. This is more easily accomplished in countries where the registration threshold is lower than in the U.K. where it is comparatively high.
(3) The ability to deduct input tax is restricted in respect of certain transactions. Any necessary adjustment to recoup this tax could quite easily be made, without varying the regulations or method of computation, by requiring an entry of the tax on the output tax return instead of requiring it, as at present, to be excluded from the input tax return.
(4) If, as in the United Kingdom, the output tax payable by small retailers is calculated by reference to the proportions of standard-rated and zero-rated goods purchased, it would be necessary to use different descriptions to distinguish purchases zero-rated because of their type as distinct from those zero-rated because of their origin.

45. A change to the zero-rating of credit transactions between registered persons could not, of course, be effected without incurring cost, both to governments and industry and commerce. This expense would, however, be incurred only once and would be small in relation to the annual saving which would be achieved.

46. There are also two other effects which the adoption of this measure would produce. Larger businesses would lose the cash flow benefits which they receive under the present form of VAT administration. Experience in the United Kingdom has shown that such companies can exert strong pressure against changes which affect their interests. The fortuitous increase in their funds which has resulted from the nature of VAT being mistaken should not be allowed to prevent the large majority of registered persons enjoying the benefits they would receive if the mistake were corrected.

47. Secondly, the reduction in fraud and evasion which would take place would be offset to a minor degree by creating the possibility of a new type of fraud, that of receiving the benefit of tax-free supplies by posing as a registered person. Since the opportunity for this would be restricted to persons making annual sales of less than the VAT registration level the greatest risk of this is in countries such as the United Kingdom where this level is relatively high. Even so it would require over 15,000 successful frauds a year of this nature to offset the estimated minimum loss from input tax fraud alone in the United Kingdom. In each case the person would also have to persuade a supplier to allow him credit on his purchases. In practice little revenue would be lost.

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PERU:

Branches of Foreign Companies – Income and Patrimony Tax Regimes

By Estudio Martinez, Bellido, Berninzon & Lavalle

TOMAS O. BUCKLEY

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INTRODUCTION

Foreign companies may establish branches in Peru. Both the Constitution of the State as well as the General Law of Companies provide for rules which guarantee the creation and operation of branches of foreign companies.

Fundamental rights such as contracting for lawful purposes and the right to private property, among others, are expressly recognized by the Political Constitution of Peru of 1979.

But the General Law of Societies, whose Single Revised Text was approved by Supreme Decree No. 003-85-JUS dated 14 January 1985 provides the requirements that the branches of societies domiciled abroad must satisfy such as: the obligation to register at the Public Register of the place where it operates in the country; the obligation to have a legal representative duly appointed, indicating his powers in a clear and precise manner; and other obligations of a mercantile nature.

The two main laws concerning the assessment of income of branches of foreign companies are the Income Tax and Patrimony Tax.

I. INCOME TAX REGIME

1. Legal basis

1.1 The Single Revised Text (SRT) of the Income Tax Law approved by Supreme Decree No. 300-805-EF dated 12 July 1985.

1.2 Regulations. Supreme Decree No. 529-85-EF dated 27 December 1985.

1.3 Modifications. Legislative Decree No. 362 dated 27 December 1985.

2. General provisions

For income tax, the branches of foreign companies are considered juridical persons domiciled in Peru like any Peruvian company (item(e) of Article 7 and item (i) of Article 13 of the SRT) and must pay taxes on all their Peruvian-source income (second part of Article 6 of the SRT and point 3 of item (b) of Article 20 of the Regulations).

Peruvian-source income is considered to be the following:

- The income produced by establishments located in the country.
- The income produced by capital, goods or rights physically located or placed or economically used in the country.
- The income originated from personal work or civil, commercial activities or of any nature performed in the country.
- The income obtained from the disposition of shares or participations representing the capital of companies or societies organized in the country. This income is only subject to tax in the case contemplated in point 6 of item (b) of Article 3 of the SRT, that is, when the goods which constitute the assets of juridical persons or companies organized in the country or of permanent establishments of companies organized abroad engaged in activities which generate third-category income are sold (Art. 9 of the SRT).

The following are also considered as Peruvian-source income:

- Interest, commissions, premiums and every amount in addition to the interest agreed for loans, credits or in general any capital placed in the country.
- The interest on obligations, when the issuing entity has been organized in the country, regardless of the place of issuance or location of the goods affected by the guaranty.
- The salaries and any type of remuneration that the

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companies domiciled in the country pay to the members of their administrative bodies acting abroad.
- Royalties. The royalties for technical, economic, financial and other types of assistance rendered abroad by state entities or international organizations are not subject to tax (Article 10 of the SRT).

The income obtained by the branches of foreign companies for purposes of the tax are considered as third-category income, that is, those derived from commerce, industry, mining; from activities related to agriculture and stock-raising, forestry, fishing and to other natural resources; from the rendering of commercial, industrial and other types of similar services such as transportation, communications, sanitation, hotel, warehouses, garages, repairs, constructions, banks, financial entities, insurance, bonds and capitalization; and, in general, any other activity which constitutes a customary business of purchase or production and sale, exchange or disposition of goods (Art. 28 of the SRT).

3. Form of taxation

For the branches of foreign companies there are two regimes for the payment of income tax.

The first one consists in the application of the tax on the taxable income determined like any Peruvian company; we will call this *General Regime,* and the second consists in the calculation of the tax on the taxable income established by applying the percentages indicated in the law according to the activities developed in the country; we will call this *Presumed Net Income Regime.*

In both cases the scale in Art. 62 of the Single Revised Text of the Income Tax Law, as superseded by Legislative Decree No. 362, is applicable:

Article 62

The tax applicable to juridical persons domiciled in the country will be determined by application of the following scale on their taxable income:

Taxable income	Rate
Up to 75 tax units	20%
In excess of 75 tax units	40%

And, in addition, a 30% rate on the "Income Available to the Titleholder Abroad"; that is, the taxable income of the branch or agency in the country; plus the amount of the proceeds for tax-exempted interest and dividends earned during the year; less the amount of the tax paid in fulfilment of the provisions set forth in Art. 62 mentioned above; and less the amount of the other deductions permitted by the law.

The additions to the income for amounts which may be capitalized and depreciation, amortization and excess provisions or provisions not permitted also form part of the income available to the titleholder abroad, except the provisions which must be used in the next tax year, without prejudice to the adjustments to the taxable profits of the subsequent tax years as a consequence of the amounts added as indicated above (Art. 121 of the Regulations).

The expenses resulting in taxable income for the branches do not form part of the available income, provided the expense, due to its nature, is subject to tax control and does not mean an indirect disposition of said income.

When the available income includes dividends distributed by juridical persons organized in the country, the income tax withholdings made thereon in accordance with item (b) of Art. 85 of the SRT and item (b) of Article 63 of the SRT, as modified by Legislative Decree No. 362, will be considered as advance payment of the tax established.

a. Branches subject to the general regime

The income consists of the group of earnings subject to tax obtained during a taxable year (a calendar year from January to December).

If the income is generated from the disposition of assets, the income will be the difference between the total net proceeds obtained from said operation and the computable cost of the good sold. If these are depreciable goods, the amount of the depreciation allowed will be deducted from the computable cost.

The total net proceeds resulting from the disposition of the goods will be established by deducting from the gross earnings the refunds, bonuses, discounts and similar concepts which are customary in said place. Computable cost of the assets disposed will be understood to be the cost of acquisition or production or, if applicable, the value of incorporation into the patrimony or the value appearing in the last inventory determined in conformity with the law.

In order to determine the income tax for the income obtained, the expenses necessary to produce and maintain its productive source may be deducted insofar as the deduction is not expressly prohibited (Art. 35 of the SRT).

Consequently, the following concepts are deductible from the third category in accordance with Art. 40 of the SRT:
- The expenses inherent in the taxed business or activity.
- The interest on loans and the expenses derived from the extension, renewal or payment of same, provided these have been contracted to acquire goods or services related to the obtention or production of income taxed in the country or to maintain its productivity, subject to the limitations provided by law.

Only the amount of the interest referred to in the preceding paragraph in excess of the amount of the proceeds from exempted interest is deductible.

For such purpose, the exempted interest generating from securities acquired in fulfilment of a legal disposition or of dispositions from the Central Reserve Bank of Peru and the interest generating from securities

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accruing interest in national currency not exceeding 50% of the re-discount rate established by the Central Reserve Bank for commercial banks will not be computed.

In the case of financial banks and companies, the ratio existing between the taxed financial proceeds and the exempted financial proceeds must be established and only the charges can be deducted as expenses according to said proportion for taxed financial proceeds.

- The tributes assessing goods or activities which produce taxed income.
- The insurance premiums covering risks for operations, services and goods which produce taxed income, as well as the occupational accidents of their personal and business interruption.
- The extraordinary losses of the goods which produce taxed income due to an act of god or force majeure or to offences committed to the detriment of the taxpayer by his dependents or third parties, as to the portion in which such losses are not covered by indemnities or insurances and provided the offence has been judicially proven.
- The expenses for collection of taxed income of this category.
- The depreciation for wear and tear or obsolescence of the fixed assets and the shrinkages and impairments of the stocks duly verified.
- The organizational expenses, the initial pre-operating expenses, the pre-operating expenses resulting from the expansion of the company activities and the interest accrued during the pre-operation period, to the taxpayer's option, may be deducted during the first tax year or amortized proportionally during a maximum term of ten years.
- The allowances destined to set up reserves and other deductions ordered by the Superintendency of Banks and Insurance as well as the technical reserves of the capitalization insurance company. Those corresponding to the previous tax year not used will be considered as a benefit subject to tax of the taxable year.
- The write-offs for bad debts and the equitable provisions for the same concept, provided the accounts to which these correspond are determined.
- The allowances destined to set up provisions for social benefits established in conformity with the pertinent legal dispositions.
- Retirement pensions and pension funds paid by the companies to their employees or relatives, in accordance with the pertinent legal dispositions, as to the portion not covered by any insurance. In the case of banks, insurance companies and public-utility companies, they may set up retirement provisions for the payment of the pensions established by the law, provided the official entity in charge of supervising them so orders.
- The bonuses, gratuities and retributions agreed for the personnel, including all payments made for any concept in favour of the employees by virtue of the existing labour relationship and to retiring employees. These retributions may be deducted in the business year to which these correspond when these are paid within the term established by the Regulations for the filing of the tax return corresponding to said year.
- The expenses and contributions destined to render health, recreational, cultural and educational services to the personnel as well as the expenses for the sickness of any employee.
- The exploration, preparation and development expenses incurred by the holders of mining activities that will be deducted in the year these are incurred or will be amortized during the periods and under the conditions provided for in the General Mining Law and in the complementary and regulatory dispositions thereof.
- Royalties in conformity with the provisions set forth in the Regulations.
- Representation expenses inherent in the trade or business, as to the part which in the overall does not exceed 0.5% of the gross earnings, subject to a maximum limit of 80 tax units.
- The travel expenses for trips which are indispensable according to the activity which produces the taxed income.
  The need to travel will be evidenced by the correspondence and any other pertinent documents and the expenses by the receipt of the tickets and a viaticum, which may not exceed twice the amount granted for said concept by the Central Government to its top career officials, will also be accepted.
- In the case of leasing contracts, the periodic instalments and the repair, maintenance and insurance expenses are deductible by the lessee.
- The expenses for operation and maintenance of motor vehicles which are indispensable for the development of the activities inherent in the business or company, including the insurance expenses and rental of said vehicles.

Without prejudice to the deductions mentioned above, the amounts paid during the tax year for the following concepts may be deducted.

- The real estate tax and the patrimony taxes created by Art. 19 of Law 23724 (Tax on Automotive Patrimony, etc.).
- Donations made in favour of the entities indicated by the Law and the civic allowances destined to charitable establishments and institutions, institutions rendering social assistance, education, scientific or cultural research. The deduction will be admissible provided the total amount thereof does not exceed in each taxable year 10% of the net income of same before deducting the amount of the donations. The donations in favour of universities and related entities declared as such by the Executive will be deductible in their entirety and will also qualify for an income tax credit equivalent to 25% of the amount of the donation (Art. 36 of the SRT).

Just as deductions are established, in accordance with Art. 50 of the SRT, these are not accepted as such to determine the tax.

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Income tax

The fines, surcharges and other penalties applied by the National Public Sector.

Donations and any other acts of release of money or donations in kind, except those contemplated above.

- The amounts invested in the acquisition of goods or permanent improvements.
- The allowances destined to set up reserves or provisions the deduction of which is not admitted by this law.
- The amortization of goodwill, trademarks, patents, manufacturing processes, gratuities and other similar intangible assets. However, the price paid for the intangible assets, at the taxpayer's option, may be considered as an expense and applied to the profit and loss of the business in a single tax year or amortized proportionally within a maximum term of ten (10) years.

The General Tax Bureau, after obtaining the opinion from the pertinent technical entities, will be authorized to determine the real value of said intangible assets for tax purposes, when it considers that the price assigned is not consistent with reality. The foregoing rule is not applicable to intangibles contributed; their value may not be considered to determine the profit and loss.

- The losses originating from exchange differences derived from foreign credits, to the extent these exceed, alternatively and to the taxpayer's option, three times the net worth of the debtor entity in the country or four times its corporate capital at the close of the tax year applied to the obtention of taxed income.
  The net worth is composed of the amount of the patrimony actually brought to and established in the country, in cash or in capital goods, plus the workers' profit sharing, the revaluation surpluses up to the authorized proportion, the patrimony reserves, the credit balance of the account with the home office, less the amount of the depreciation remitted and any other credit balance with entities economically related to the company or to its home office. The accumulated results of the credit balance of the account with the home office, as the case may be, includes the profits of the tax year before the profit and patrimony participations of the workers, labour union and board of directors, contributions for scientific and technological research and before the tax.
  In the cases in which, as a result of the studies, it is proven that the limits fixed in the preceding paragraph do not conform to the requirements of certain activities, the Ministry of Economics and Finance, with the favourable report of the General Tax Bureau, may modify the limits mentioned in the preceding paragraph.
- The amounts paid as interest to entities economically related to the debtor, as to the portion in which the rate thereof exceeds the limits fixed by the Regulations, taking into account the type of operation, as well as the interest corresponding to the portion of the credits which exceed, alternatively and to the taxpayer's option, three times the net worth of the debtor company or four times its corporate capital at the close of the tax year. Net worth is understood to be the one defined in the preceding point. This disposition will not be applied to the cases referred to in the preceding paragraph. The maximum rate will be the prime rate prevailing in the place where the credit comes from; in the cases of credits destined to the construction, acquisition and installation of new fixed assets or to working capital, the maximum rate mentioned above will be increased by three points. Said three points cover the expenses and fees, premiums and any other amount in addition to the agreed interest paid to foreign beneficiaries.
- The mercantile commissions originating abroad from the purchase or sale of merchandise or other types of goods, as to the portion exceeding the percentage usually paid for said commissions in the country where these originate.
- The loss originating from the sale of securities acquired enjoying a tax credit, up to the limit of said benefit.

b. Branches subject to the presumed net income regime

In order to fall within the scope of application of this regime, the branches must carry out the activities indicated below. Their taxable income subject to income tax will be determined by applying the percentages also indicated below to their income obtained in the country.

a. Transport and communications between the Republic and overseas:
(1) 5% of the gross earnings for radiograms, telephone calls and other similar services rendered from the territory of the Republic to overseas;
(2) 1% of the gross earnings for air transportation and 2% of the gross earnings for sea transportation, except for the cases in which, due to reciprocal treatment given to Peruvian lines operating in other countries, the foreign lines established in such countries are exempted from income taxes.

b. International news agencies: 10% of the gross remunerations obtained from the release of news and general information or graphic material to domiciled persons or entities or persons or entities using said material in the country.

c. Distribution of cinematographic films and similar ones to be used by domiciled natural or juridical persons: 20% of the gross earnings obtained from the use of cinematographic or television films, "video tapes", radio serials, phonographic records, comic strips and any other similar means for the broadcasting, reproduction, transmission or diffusion of images or sound.

d. Technical services which require the performance of activities, part in the country and part abroad, rendered by non-domiciled juridical persons: 40% of the gross earnings obtained by them.

e. Operations related to the exploration, drilling, de-

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velopment and transportation in the oil industry: 25% of the gross earnings of non-domiciled service contractors and/or subcontractors, performing specific works under contracts executed in Peru or abroad.

In the cases of service contractors and/or subcontractors domiciled in the country, the minimum taxable income will be 15% of the gross earnings originating from works related to exploitation, drilling, transport and development operations of the oil industry under contracts executed in Peru or abroad.

f. Demurrage of containers to be transported: 80% of the gross earnings obtained by non-domiciled taxpayers for excess containers.

g. Transfer of television re-broadcasting rights: 20% of the gross earnings obtained by non-domiciled taxpayers from the transfer of rights for the re-broadcasting by television in the country of events performed abroad.

4. Income tax advance payments

In accordance with Art. 81 of the Income Tax SRT, as amended by Legislative Decree No. 362, juridical persons, in this case branches, must pay as payment on account of the income tax that they must definitively pay for the taxable year, monthly instalments to be determined *at their option* according to any of the following systems:

- For each one of the first 2 months a portion of the tax paid in the tax year preceding the previous year and for the remaining months a portion of the tax paid in the previous tax year, in accordance with the provisions fixed by the Ministry of Economics and Finance for each taxable year.
- By fixing the instalment based on the taxable income established according to the monthly balance sheet in the month it is obtained.
- In the case of juridical persons starting their activities or which have not obtained taxable income in the immediately preceding year, by fixing the instalment at 2% of the gross earnings obtained in the same month. For such purpose, gross earnings will be considered to be the total third-category taxable income obtained in each month.

In the event none of the systems is selected, the General Tax Bureau will assess at its own initiative using the first or third system, even if the juridical persons do not fall under the cases contemplated therein.

5. Tax returns – Calculation and payment of the tax

The branches of foreign companies are obliged to file an income tax return (Art. 148 of the Regulations).

The tax return corresponding to each taxable year must be filed using the form to be issued for such purpose by the Tax Bureau and at the fiscal domicile of the taxpayers or, as the case may be, of the persons responsible for the tax.

The term to file said tax return will expire on 31 March of the following calendar year (item (a) of Art. 153 of the Regulations), they must also calculate in their tax returns the tax on the income available to the beneficiary not domiciled in the country (Art. 76 of the SRT).

II. PATRIMONY TAX

1. Legal basis

1.1 Decree-Law No. 19654 dated 12 December 1972.

1.2 Regulations under Supreme Decree No. 096-73-EF dated 29 May 1973.

1.3 Amendments:
Legislative Decree No. 213 dated 12 June 1981.
Decree-Law No. 23552, Art. 19; Supreme Decree No. 278-84-EFC dated 22 June 1984, Art. 4.
Law No. 24030, Arts. 27, 28, 30, 31, 32.
Supreme Decree No. 108-85-EF dated 15 March 1985.
Supreme Decree No. 176-85-EF dated 2 May 1985.
Supreme Decree No. 169-86-EF dated 16 May 1986.
Legislative Decree No. 362 dated 27 December 1985.

In general terms, the patrimony tax is a tribute of annual periodicity whose purpose is to tax the net worth of companies, among these the branches, at the close of each business year.

2. Subjects of the tax

The branches as companies generating third-category income, in accordance with the income tax provisions, are considered as passive subjects for purposes of the patrimony tax.

3. Tax base

Art. 4 of Decree-Law No. 19654, as amended by Legislative Decree No. 213, provides that for application of the tax, the tax base is the net worth of the companies, also including the branches, at the end of each tax year.

For such purposes, net worth is considered to be the difference between the value of the goods appearing under assets and third-party liabilities. Likewise, said disposition provides that in order to determine the value of the fixed assets, the participations and other rights representing the capital of other companies included with the scope of application of the patrimony tax are not considered for purposes of calculating the tax.

The depreciation recorded on the books in accordance with the pertinent dispositions must be added to determine the value of the fixed assets.

On the other hand, Article 7 of Supreme Decree No. 096-73-EF, which regulates the patrimony tax, provides that in order to determine the value of liabilities, the third-party liabilities and the provisions will be considered, less the advances made.

Third-party liabilities must be understood to be those made between persons not economically related. In

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relation to the concepts of "third-party liabilities" indicated above, with respect to companies economically related, our tax jurisprudence has established, in principle, that the obligations contracted with entities somehow related to the company or to its home office are not third-party liabilities.

The same provision is contained in Supreme Decree No. 108-85-EF, which modifies Art. 5 of Supreme Decree No. 096-73-EF, when it indicates that the obligations contracted with companies economically related to the company or to its home office, in the event the creditor is an entity domiciled abroad, not subject to patrimony tax, are not considered as third-party liabilities.

Consequently, the branches, in order to determine the net taxable patrimony, must neither deduct the debts contracted with their home office nor with a company related to it.

However, our tax legislation has not established the ruling principles to determine the concept of economic relationship with respect to the application of the patrimony tax.

For such purposes, the doctrine, which determines that an economic relationship exists when the formal juridical independence is neutralized by a financial and economic or administrative subordination, is applied.

In this sense, and taking into consideration the criteria mentioned above, the Tax Bureau can determine that two juridically different persons are linked by a group of interests, for which it disregards the juridical forms to appreciate the true economic reality of same.

Finally, the branches or agencies of companies, in order to determine their net worth, will consider as capital the one assigned and actually brought to the country by the home office, the credit balance of the account with said home office appearing in the balance sheet and another credit balance with entities economically related to the company or to its home office, in conformity with the provisions set forth in Art. 15 of Supreme Decree No. 096-73-EF, as modified by Supreme Decree No. 108-85-EF.

4. Deductions to determine the tax base

When the branches have not set up provisions for expenses and taxes, to determine the net worth they can make the following deductions:

(a) The gratuities and other similar retributions to the personnel when in one case or the other said retributions correspond to the tax year.
(b) Withdrawals from profits corresponding to the tax year.
(c) The income tax calculated as of the close of the tax year.

It must be borne in mind that the deductions referred to in items (a) and (b) depend on whether the respective amounts are paid or made available to their beneficiaries within the term established for the filing of the corresponding tax return.

5. Tax scale

The tax will be calculated by applying the following progressive scale:

	Rate
Up to 15 tax units	1 %
For the excess of 15 tax units	2.5%

6. Tax return

The branches must file, on an annual basis, the corresponding tax return with the General Tax Bureau, using the same form used for income tax.

7. Advance payments

The patrimony tax must be paid in four instalments, the first three of which will be considered as advance payments and will be paid during the tax year. The last instalment will be considered as a regularization payment and must be paid at the moment of filing the tax return.

The Ministry of Economics and Finance will establish the pertinent rules in each tax year for the payment of the aforementioned instalments.

8. Reduction of the advance payments

The branches may modify the amount of the next instalments, once they have paid the first instalment, when their patrimony has been reduced by more than 50% with respect to the previous tax year and will modify the amount of the instalments according to the new value of the patrimony. The modifications of the respective instalments must be notified to the General Tax Bureau within 30 days after said modification is made.

9. Excess advance payments

When excess advance payments are made, the branches may apply said excess to the payment of the instalments of the next tax year or request the refund thereof.

10. Tax credit

The branches may apply as credit against the patrimony tax the following amounts:

- The payment made for the real estate tax.
- Against the regularization payment, the total amount of the automotive patrimony tax.

Finally, there is one case in which the companies in general are not obliged to make advance payments during their first tax year. These are the companies whose first tax year is smaller than 12 months. The tax will be determined based on the relation between the period of said tax year and the annual period and must evidence the full payment at the moment of filing the tax return.

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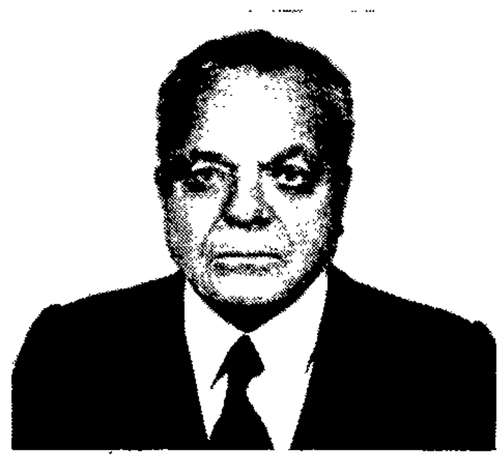
GREECE:

An Anti-Incentive for Foreign Investments



By G.A. Nezis*

The companies that have been under the provisions of the Legislative Decree (L.D.) 2687/1953 (foreign investments) are entitled by the relative approval Acts to express their capital stock, keep their books and prepare their balance sheets, using the foreign currency in which their capital was imported (capital stock and debt capital).

Up to the 1974 fiscal year, the tax authorities allowed these companies, under Art. 9, L.D. 2687/53, to state the depreciation of the value of fixed assets, as it appears in the balance sheets and the books of the investing company, in dollars.

The rate, 1 U.S. dollar equals 30 Drs., that was established in 1953 and remained virtually unchanged for 22 years, has started to float since 1975 due to the continuous devaluation of the drachma.

As concerns companies under Art. 9, L.D. 2687/53 with balance sheets expressed in dollars, the Tax Administration issued its E 4727/1977 decision maintaining that:

> The differences arising from fluctuations of the exchange rate of the U.S. dollar – between the fixed asset's creation year and its subsequent depreciation years – should not affect its drachma equivalent value based on the exchange rate in effect during the fixed asset's creation year.

From 1975 to 1976, in a series of articles that appeared in "Vima" and "Ikonomikos Tahidromos", I argued that exactly the same amount of depreciation ought to be accumulated against the value of the fixed asset as is being consumed whether the balance sheet of the company is expressed in drachmas or in dollars.

The financial circuit of the depreciable value of the fixed assets and the monetary means that were disposed for their acquisition must be confronted with an overall and cyclical view so as to be given a legitimate, fair and rightful solution, for – in the end of the asset's complete write-off year – the accumulated depreciation fund expressed in dollars to be equal with the amount of dollars that the investor imports into Greece for his investment in fixed assets.

The separation – between the fixed asset and the monetary means – that the above-mentioned decision implies, creates an unfair tax against these industrial companies, as it becomes apparent from the following example, the computations of which are based on the assumption that:

(a) the rate of the dollar was at the end of the first year 30 Drs., second year 60 Drs., third year 90 Drs., fourth year 120 Drs. and fifth year 150 Drs.;
(b) the company has imported from abroad: US$ 1,000,000 for capital stock and US$ 5,000,000 for debt capital repayable by five annual instalments;
(c) the capital stock as well as the debt capital were turned into depreciable fixed assets during the year that the dollar rate was 30 Drs.; and
(d) the annual depreciation rate is 20% of the fixed asset's value.

Based on the afore-mentioned, the depreciation of the fixed assets at the end of the following years will be:

	Value in US$			*Value in Drs.*
A' year	1,200,000	times	30 equals	36 million
B' year	1,200,000	times	60 equals	72 million
C' year	1,200,000	times	90 equals	108 million
D' year	1,200,000	times	120 equals	144 million
E' year	1,200,000	times	150 equals	180 million
Total	6,000,000			540 million

The Ministerial Decision recognizes total depreciation:
(US$ 6,000,000 x 30 = 180 million Drs., x 20% = Annual depreciation 36 x 5 years i.e.
Total Depreciation) 180 mill. Drs.
Depreciation loss 360 mill. Drs.

After the Ministerial Decision has been made effective the investor loses two thirds of his depreciation, with the consequence of having, at the end of the fifth year, no available US$ equal to that which was imported into Greece (6,000,000) but a sum substantially lower.

As a result, the existing industrial companies under L.D. 2687/53 (foreign investments), with balance sheets in US$, are led to a disaster because they will be called to pay huge sums in taxes (main and fines) upon non-existing profits, that arise fictitiously – independently of their will – by the application of the Ministerial Decision. And this because total depreciation should be 540 mill. drachmas as if the balance sheet of the investing company was expressed in drachmas instead of US$.

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COLOMBIA:

New Tax Developments

By James Leavy

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1. Elimination of income tax returns for employees

In Colombia, individual taxpayers were required to file an income tax return for each fiscal year if their gross income or their gross assets on the last day of the fiscal year or period exceeded the amounts determined annually by the Government (in 1985, income of Col. $ 290,000 or gross assets of Col. $ 770,000).

Decree 460 of 1986 introduces an important innovation: the "Certificate of Income and Withholdings". For most taxpayers, the Certificate of Income and Withholdings is considered a substitute for an income tax return and, consequently, eligible taxpayers are not obliged to file a tax return.

Beginning in fiscal year 1985, the income and complementary tax return is eliminated for employees who receive at least 80% of their gross income from salaried employment provided that the following additional requirements are met:

a. salaries and other gross income originating from employment or from other sources must have been subject to withholding at source;
b. the salaried employee's gross assets on the last day of the fiscal year or period must not exceed Col. $ 5 million;
c. during the pertinent fiscal period, the salaried employee must not have been liable as a collection agent for sales tax (VAT) and on the last day of the fiscal period he must not have an interest in a limited liability company (sociedad de responsabilidad limitada) or similar entity.

2. Remittance tax and petroleum activity

Article 29 of Law 7 of 1986 re-establishes the profit remittance tax for foreign petroleum enterprises.

This repeals Article 46(3) of Law 9 of 1983 which exempted such enterprises from payment of remittance tax.

The remittance tax reappears for oil companies at a time when Colombia is returning to self-sufficiency in oil and will become an exporter of oil and coal.

The remittance tax is assessed as follows:

a. Twenty percent of amounts remitted as profits of a branch (sucursal) established by the foreign company in Colombia after payment of a withholding tax of 14% on amounts paid by the branch to the foreign company.
b. Twelve percent of amounts remitted as profit from an interest held by the foreign company in a limited liability company (sociedad de responsabilidad limitada) or similar entity after payment of a withholding tax of 40% on profits distributed or credited to the foreign company. (Note that dividends paid by corporations (sociedades anónimas) to their foreign shareholders are not subject to remittance tax.)

3. New rules on withholding at source

Article 1 of Decree 870 of 1986 (14 March) declares that for fiscal year 1986 the following amounts constitute neither income nor capital gains subject to withholding at source:

a. Forty percent of interest payments or amounts for monetary correction received by individuals or estates on savings accounts held by them in the UPAC system (essentially a savings scheme incorporating a correction mechanism for the decline in purchasing power of the peso and designed to finance housing construction).
b. Twenty-seven percent of the amounts received by individuals and estates from the following types of investment (excluding savings accounts in the UPAC system):
   1. accounts or investments with entities subject to inspection and supervision by the Banking Superintendency, whose corporate purpose is to act as a financial intermediary;
   2. public debt instruments;
   3. bonds issued by sociedades anónimas;
   4. corporate securities of sociedades anónimas authorized by the National Securities Commission.

Article 5 of Decree 870 modifies withholding at source on indemnities paid or credited to employees who are permanently laid off. The decree also establishes, for the first time, an indemnity in the case of voluntary retirement by workers, and rules governing withholding at source for such indemnities.

4. Tax control of non-profit entities

Decree 1,990 of 1986 (24 June) modifies the rules on tax information which non-profit entities (which are not liable for income and complementary taxes) must present yearly to the National Tax Administration. These rules aim at controlling tax evasion through such entities.

Non-profit entities must provide information concerning names and Tax Identification Numbers (NIT) of the persons or entities from whom donations in excess of Col. $ 290,000 were received and the names and NITs of the beneficiaries of payments in excess of Col. $ 290,000 made by non-profit entities. They must also

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provide a general financial statement as of 31 December of the corresponding fiscal year and their income and expenses statement for the period.

5. Flexible depreciation of real property

Decree 1,649 of 1976 provided for a flexible depreciation system during the useful life of depreciable assets, provided annual depreciation of an asset in any one year did not exceed 40% of the cost.

Decree 3,838 of 1985 eliminated this depreciation system for real property and for goods imported to Colombia under temporary licence. These could only be depreciated on a straight-line basis or by the system of constant percentage reduction of non-depreciated value (declining balance depreciation).

Decree 1,773 of 30 May 1986 (which formally abrogates Decree 3,838) restates the exceptions to the flexible depreciation rule provided for in Decree 3,838, but substitutes the expression "buildings" for "real property" and defines "buildings" to mean construction destined for housing or for analogous uses such as factories, offices, churches, theatres or similar.

THE ISLE OF MAN :

Your "User-Friendly" Offshore Centre

By Charles Cain

INTRODUCTION

For the last fifteen years the Isle of Man has been steadily growing in significance as an offshore financial centre. And yet even now, there are many international tax planners who are unaware of the facilities that the Isle of Man has to offer. This article is intended as an overview. It is not a detailed description. As you read on it will be clear that the facilities on offer are so wide-ranging that even a substantial book would be inadequate.

This is particularly so since every year sees some change to the legislative infrastructure, improving the facilities yet further.

1. POLITICAL STATUS

1.1 The Constitution

The Isle of Man is not, and never has been, a part of the United Kingdom. It is not represented in the U.K. Parliament. It receives no money from the United Kingdom. It is, as it has always been, a totally separate and stable jurisdiction. It derives from an ancient Norse/Gaelic Kingdom of the ninth century. Until 80 years ago, Gaelic was the common language. Its political institutions are derived from that Norse Kingdom. Its Parliament, Tynwald, is a Norse-style Parliament, which celebrated its 1000th anniversary in 1979. Tynwald is a Sovereign Parliament. It does not owe anything to the British Parliament which is younger and is constitutionally incapable of interfering with Tynwald.

The Isle of Man is a totally separate, self-governing and self-reliant state. In international law, the United Kingdom is responsible for the international relationships of the Isle of Man, and for its ultimate "good government". But it takes no part, and has no constitutional authority to take any part, in the internal government of the Isle of Man.

Thus, while the Isle of Man is not technically a "sovereign" State, it in fact has more of the ingredients of "sovereignty" than more so-called sovereign States.

The Queen of the United Kingdom is Queen of Mann, or to use the style preferred in the Isle of Man, the Lord of Mann. She is represented by a Lieutenant Governor who receives visiting Heads of State in her name. The Monarch's role is not derived from feudal origins, as is the case in the Channel Islands, but from that ancient Sovereign Kingdom.

The precise modern constitutional relationship between the Isle of Man and the United Kingdom is complex. It is enough to say that the Isle of Man is very jealous of its independence, and that the objective of most Manx politicians is for the Isle of Man to proceed in an orderly manner towards complete sovereign independence in due course. The author of this article believes that this will happen by the end of the century. (It is worth noting that the United Kingdom has already offered sovereign independence and has indicated officially that it will assist in any way it can towards this goal if the people of the Isle of Man desire it.)

Economically, the Isle of Man is much less tied to the

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United Kingdom than it used to be. The growth of international finance and of a substantial manufacturing industry has strengthened its international economic interests, while the decline of its tourist industry has diminished its dependence on earnings from the United Kingdom.

There are, however, three areas of substantial ties with the United Kingdom:

(a) Customs and excise. The Isle of Man is in a Customs Union with the United Kingdom. There are thus no barriers to trade between the Isle of Man and the United Kingdom, and the Isle of Man levies identical customs and excise duties, and value added tax.
(b) Common citizenship. There is, of course, no such thing as a United Kingdom citizen. There are only British citizens. Thus people from the United Kingdom carry a U.K. passport which states "British citizen". And similarly Manx people carry an Isle of Man passport which states "British citizen".
(c) Common travel area. There are no restrictions on travel between the Isle of Man and the United Kingdom. Consequently, the Isle of Man applies identical immigration and visa requirements as the United Kingdom.

1.2 The law of the Isle of Man

Since the Isle of Man is an entirely separate jurisdiction with its own sovereign Parliament (Tynwald), it is not surprising that it has its own law and its own judiciary.

Manx law is derived from Norse law but today is very similar to that of England. Acts of the United Kingdom Parliament do not, today, apply to the Isle of Man unless Tynwald so resolves (this is a rare occurrence). Manx law, being derived from common law, contains the concept of "equity" and equitable trusts, for example, existed in the Isle of Man over five centuries ago.

The Manx legal profession is quite distinct and English solicitors, for example, have no legal standing in the Isle of Man. Only Manx advocates are recognized. The Isle of Man has its own courts, its own judges and its own appeal procedures.

1.3 The European Community

When the United Kingdom joined the EEC, special arrangements had to be made for the Isle of Man. As a result, a special Protocol was signed. By virtue of this the Isle of Man:

(a) Is *not* a Member of the EEC.
(b) Is treated as inside the EEC Customs area.
(c) Enjoys the rights to freedom of trade and freedom of movement of capital.
(d) Does *not* enjoy freedom of movement of labour. Manx people without EEC family connections do *not* have the right to work in the EEC (other than the U.K. or Ireland) and, similarly, non-Manx people need work permits to work in the Isle of Man.
(e) Does *not* pay any money to EEC funds and is *not* eligible to receive any money from EEC funds.
(f) Is *not* required to harmonize its law or fiscal arrangements with EEC directives.

As a result a trading company in the Isle of Man is treated as an EEC company for all commercial and customs purposes. This is of considerable significance for the growing Manx manufacturing industries.

1.4 The world

Since the United Kingdom is responsible for the international affairs and defence of the Isle of Man (for which the Manx Government pays a substantial amount each year), the Isle of Man has no overseas diplomatic representation. However, the Manx Government does have a number of honorary "consuls" overseas whose job is essentially social.

Relationships with international bodies and other governments are conducted through the United Kingdom. At times this produces difficulties; on some matters the U.K. Government has found itself presenting a Manx policy with which it disagrees itself!

With some governments the Isle of Man Government maintains unofficial but close links both for practical reasons and for social/historic reasons. For example, relationships are maintained with the Republic of Ireland, Iceland and with Norway. There is a special parliamentary group in the United Kingdom Parliament. There are links with the Government of the U.S.A. When the Isle of Man becomes sovereign independent, these links will be of inestimable value.

2. COMPANIES AND TRUSTS

2.1 Company law

Modern Manx company law is based on the Companies Consolidation Act 1931 which itself is virtually identical to the United Kingdom Companies Act 1929. However, since that time, Manx company law has seen amendment and change and this has led to a substantial divergence from modern U.K. company law.

The most recent amendment is the Companies Act 1986 which has yet to come into force. When this does come into force, Manx companies will not require any objects and the difference between private and public companies will become minimal. In essence, a private company may not offer its shares to the public and need not file its annual accounts while a public company may offer its shares through a "prospectus" and must file its accounts. Private bearer share companies will become available. But the range of types of companies available is striking.

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(a) Companies limited by shares: These are conventional companies with limited liability, issuing shares to their members.
(b) Companies limited by guarantee: These companies do not issue shares at all. Members are elected and need subscribe no money at all. However, if the company does become insolvent, they are liable to pay a prescribed sum (e.g. £ 10) each. These companies lend themselves to creative structuring and can be adapted to a wide range of requirements.
(c) Companies limited by guarantee and having shares: These companies are even more flexible than pure guarantee companies, having a capability of members who hold shares and members who do not, with differing rights attached to different classes of members. Such companies are not widely used but they do have a remarkable flexibility for creative structuring.
(d) Unlimited companies having shares: These companies are not widely used but have a capacity for restructuring their own capital which has been of significance in the context of tax planning or asset protection planning.
(e) Limited partnerships: While not, strictly speaking, companies, these limited partnerships also provide a vehicle with considerable planning flexibility.

In general the following further points about Manx companies may be noted:

(a) Manx companies can issue redeemable shares, which can be redeemed out of profits or share premium account.
(b) There is no such thing as a "nominee" director. Directors of a Manx company are responsible for the affairs of the company and this responsibility (and the power that goes with it) cannot be taken away.
(c) There is a requirement that every Manx company has audited accounts prepared annually.
(d) A Manx company must hold an annual general meeting each year.
(e) A Manx company which is trading in or with the Isle of Man or U.K. must consider the implications of value added tax.

It is therefore of importance that the managers or secretaries of the company in the Isle of Man know what they are doing. Regrettably, there are some people who do not.

2.2 Trusts

We have already noted that "equity" is a fundamental part of Manx law. Indeed, there are only two European offshore jurisdictions which do have equity, namely the Isle of Man and Gibraltar. This is in stark contrast with the Channel Islands. In Guernsey there is neither equity nor even a statutory trust law. In terms of the European Convention on Trusts, therefore, there is no such thing as a Guernsey trust.

In Jersey there is a statutory trust law, as is the case in Liechtenstein, Monaco, Panama etc. In the absence of equity, however, such trusts *must* be viewed and handled with care.

No such problem exists in the Isle of Man. This means that the full range of trusts are available and are simply and easily established. Unless the trust is a public charity, there is no requirement for registration. Unit trusts and mutual funds are simple to structure and operate.

3. BANKING, INSURANCE, SHIP-REGISTRATION

3.1 There are now over 40 banks operating in the Isle of Man. They are not in the Isle of Man by accident. Today the banking industry is growing rapidly.
Banking (and investment management) is supervised by the Government's Financial Supervision Commission who lay down rigorous rules for banking operations. Only reputable organizations are allowed to operate banks.
Banking enjoys no tax exemptions. However, interest is paid without deduction of withholding tax. In addition, in the absence of exchange of information treaties, banking information is strictly confidential.

3.2 Insurance is also a fast growing industry. The legislation controlling insurance was recently codified by the Insurance Act 1986 and the industry is supervised by the Insurance Supervision Commission. An insurance company, all of whose underwriting risks are situated outside the Isle of Man, can obtain complete exemption from Manx tax.

3.3 In the last two years, after completion of the Island's shipping legislation, the Isle of Man has begun to attract substantial ship registration business, with some major multi-nationals registering their ships in the Isle of Man.
The Manx legislation provides for the highest standards of safety, but also provides for the ship-management companies to be tax-free.

4. MANUFACTURING INDUSTRY

With the special EEC relationship, the Isle of Man is an attractive place for manufacturing industry. The Government actively encourages industry with an attractive range of grants, loans and tax holidays available to attract manufacturing industry.

Being a large, underpopulated island, there is plenty of room for factories and there is a tradition of engineering and electronics on the island which surprises many visitors. Manufacturing industry in the Isle of Man has grown right through the recession and is as significant as finance in the island's economy.

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5. TAXATION

5.1 Residents

There are only two forms of taxation in the Isle of Man. These are income tax and customs and excise duties (including value added tax). In addition, employers and employees pay national insurance contributions related to earnings. No other forms of taxation exist.

Income tax applies to individuals and to resident companies. The standard rate is 20%. It is not likely to change. For individuals there are generous personal allowances and for companies there are a range of capital and other allowances. Dividends are treated as a charge against income before tax.

Income tax is assessed on a previous year basis, except for personal earned income which, from 1987, will be assessed on current year basis.

Customs and excise duties, and value added tax are applied identically as in the United Kingdom, with which the Isle of Man is in a customs union.

There are a number of exemptions from tax which are available to resident companies, where such companies are owned by non-residents.

(a) Insurance companies whose underwriting risks are situated outside the Isle of Man.
(b) Ship management companies whose ships ply outside Manx waters.
(c) Investment trust companies which distribute the whole of their profits each year.
(d) Investment and commodity holding and dealing companies.

5.2 Non-residents

A non-resident company is a company which is managed and controlled outside the Isle of Man. However, its affairs may be administered in the Isle of Man. Such a company is not liable to Manx income tax unless it has income arising within the Isle of Man (other than bank interest). It is, however, liable to company registration tax of £ 250 p.a. This tax is due to be abolished shortly and replaced by non-resident company duty which will be collected with the annual return filing fee. It is very probable that this will be increased in 1987, perhaps to £ 500 p.a.

The fact that such a company is not resident for income tax purposes *does not necessarily* mean it is outside value added tax. If it is trading with the United Kingdom, it may be required to register for VAT. Care needs to be taken in such a case.

A trust with non-resident beneficiaries whose income arises outside the Isle of Man (other than bank interest) is not liable to any Manx tax.

Interest on bank deposits is not liable to any withholding tax.

Apart from the above, income paid from an Isle of Man source to a non-resident is liable to withholding tax at 20%. (It is technically called non-resident income tax.)

There is only one double tax treaty in existence, with the United Kingdom. It is an old treaty and does not provide for any rates of withholding tax or recovery of United Kingdom advance corporation tax.

5.3 General

The Isle of Man tax system is simple. As such it gives a lot of scope for planning so that a non-resident can take maximum advantage of the various exemptions available.

6. CONCLUSION

It is not really surprising that the Isle of Man has become such a significant centre in the offshore world. To sum up its attractions:

(a) Strong constitutional status with totally stable government.
(b) Within the EEC for trading purposes.
(c) First class company law, providing unrivalled flexibility.
(d) First class trust law, with equity as a fundamental part of the law.
(e) First class banking law, with excellent government supervision.
(f) First class insurance law, with excellent government supervision.
(g) First class shipping legislation, providing modern ship-registration facilities.
(h) Low and "user-friendly" income tax, with a range of exemptions for non-residents using Isle of Man facilities.
(i) First class manufacturing industry incentives and facilities.
(j) A considerable body of expertise in professional firms and organizations in the Isle of Man.

What more can anyone want? It is true that we have no gold mines. But we can offer a defunct lead and silver mine or two!

And when you add to this the outstanding beauty, the fascinating history and old-fashioned courtesy and hospitality of the Isle of Man, it really is unbeatable. Even the climate is soft and gentle. It rarely gets cold and rarely gets hot. (Although the wind does blow most of the time!)

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Taxation of Foreign Companies Doing Business in Algeria

By Jean-Marc Tirard

1. INTRODUCTION

1.1 Basic facts

The specific features of the tax system applicable to foreign companies operating in Algeria are governed by that country's ideological and economic choices.

After acquiring political independence in 1962, in a socialist framework, Algeria strived for development while gaining economic independence.

Industry, and more specifically, heavy industry has been the key factor in development. On the other hand, the determination to build a socialist environment, while limiting reliance on foreign assistance meant that industrialization was entrusted to public national enterprises.

However, Algeria had neither the production capacity nor the technical know-how to achieve these objectives and therefore had to call upon foreign companies, although constraints were imposed on the scope and duration of foreign intervention.

Direct foreign investment may be made through joint ventures only, in which the Algerian Government has a majority shareholding. It is impossible to set up a subsidiary or a branch. Offices are allowed an extremely limited scope for action, as will be seen later.

These restrictions did not discourage foreign companies world-wide from operating in Algeria, and even implementing large-scale projects. In practice, however, foreign companies must confine their activities to temporary projects, such as the execution of civil engineering contracts concluded with the Algerian Government and one of the national companies.

In this context the Algerian tax law has codified the taxation of foreign companies with no permanent "installation" in Algeria, in parallel to the normal tax rules.

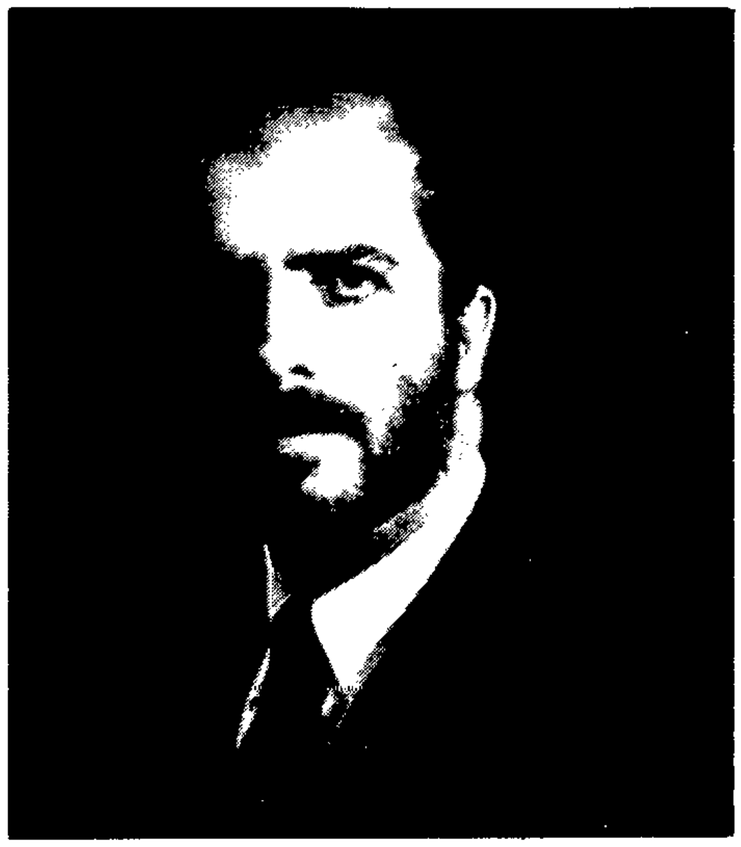
We wish to stress the importance of the tax issues raised, because of Art. 151 of the 1984 Finance Law. Indeed, according to this article:

> Any contractual provision having as an effect, within the context of the performance of a public contract, either the exemption of a national or foreign private company from the tax for which such company is liable, or the shifting of the burden of such taxes to the State, local collectivities, public agencies, public establishments and governmental entities of an industrial, commercial or agricultural nature, is null and void.

Considering the importance of the public sector, this text covers most contracts that foreign companies are likely to conclude in Algeria.

Moreover, it appears that the Algerian authorities seem to apply Art. 151 not only to the entities listed in the text, but also to any Algerian enterprise in which the State has a share. In addition, there is some concern that Art. 151 might be applied to contracts concluded prior to 31 December 1983.

This article will consider the local tax rules applying to:
contracts for building, construction and public works (2.1), contracts for the provision of general services (2.2)
which constitute the main practical means of doing business in Algeria, and the other possible forms of business enterprise:
(a) joint ventures (4.1), (b) local offices (4.2), (c) "magasins centraux d'approvisionnement" (warehouses under customs control) (4.3),
as well as certain international aspects, like the tax treaty between France and Algeria (5.1) and the uitilization of the Algerian tax as a foreign tax credit for companies operating in Algeria (5.2).



Jean-Marc Tirard is the partner-in-charge of Ernst & Whinney's tax practice in France. His area of responsibility not only covers France but also French-speaking Africa.

Born in Tunisia, Mr. Tirard began his professional career with the French tax authorities and then joined Ernst & Whinney in 1974.

He lectures on French taxation and international tax planning at the University of Paris and at the Fiscal Research at Dijon (Centre de Recherches Fiscales).

The author would like to thank his assistant, Mr. Alain Renouf, for his assistance in the preparation of this article.

ALGERIA

Area	2,382,000 km²
Population	21.2 million (1984)
Population growth rate	3.3
GNP per capita in 1984 dollars	2410
GDP in million 1984 dollars	50690
Total debt – long term (in million 1984 dollars)	12052

Sources: World Bank and French Ministry of Foreign Trade.

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2. TAXATION OF FOREIGN COMPANIES OPERATING UNDER CONTRACT IN ALGERIA

The method of taxation will depend on the nature of the contract. The Algerian direct tax code distinguishes contracts for construction works (Art. 234) from contracts for provision of services in general (Art. 80.1). In either case, the Arts. 80.1 and 234 only apply to foreign companies not having any permanent "installation" in Algeria.

In the absence of a legal definition, the term permanent "installation" seems to describe a branch or an agency under the authority of a manager who has the power and the means to conclude and execute contracts.

2.1 Taxation of a foreign company operation under a contract for building, construction, public works etc.

2.1.1 Taxation of profits (IREEC: tax on profits of foreign construction firms)[1]

According to Art. 234 of the Direct Tax Code, individuals or corporations operating under this kind of contract are subject to a flat rate tax instead of the tax on industrial and commercial profits (BIC)[2] and the tax on industrial and commercial activity (TAIC).[3]

According to the 1984 Tax Authorities' instruction, this tax covers, among other things:
- site preparation;
- building work as such;
- installation of equipment forming part of the normal, essential and permanent equipment of the building;
- road works as well as pipelines and drilling work, etc.

Contracts involving installation of equipment not permanently included in the building are seen as contracts of sale with services; the price corresponding to the service is subject to the withholding tax provided in Art. 80.1 (see 2.2.1).

According to the 1984 instruction, sums paid in connection with ancillary operations (e.g. sale of used equipment, leasing of equipment, patents) are subject to the IREEC.

The tax authorities appear to consider that all the ancillary activities involved in the construction contract must be subject to the IREEC even though they should normally be taxed as services. This position is different from that adopted to determine the borderline between TUGPS and TUGP (see 2.1.2).

The rate which was 4% was raised to 6% for contracts signed after 1 January 1985 (Finance Law for 1985).

The tax base is the gross amount, turnover tax and IREEC itself included. The tax is withheld by the Algerian client, but foreign firms are specifically held jointly and severally liable for withholdings not paid over. At delivery, taxes owed for the amount remaining due must be paid immediately to the tax collector by the foreign firm.

2.1.2 Turnover tax on production (TUGP)[4]

The scope of the TUGP applicable to construction work generally coincides with that of the IREEC. This tax is non-cumulative. The foreign company must invoice the tax to its customers but may, under certain conditions, deduct from the amount received the tax shown on its purchase invoices. The net tax is payable monthly.

The tax base is the price invoiced, all taxes included, on building activities and services in connection with the building works. However,it seems that tax authorities make a distinction between services directly related to the building activities and subject to the TUGP and all other services subject to the TUGPS.

The rate of TUGP on construction work is 10%. As a general rule, tax is due on receipt of payments; at delivery, however, TUGP owed for the amount remaining due must be paid immediately to the tax collector.

2.2 Contract for provision of general services

2.2.1 Taxation on profits[5]

According to Art. 80.1 of the Direct Tax Code, sums paid by a payor established in Algeria are subject to withholding tax when paid to individuals or corporations liable for the tax on industrial and commercial profits (or non-commercial profits) for services of any kind rendered or used in Algeria.

Withholding tax is expressly applied to sums paid in connection with rights over industrial property.

In general withholding tax applies to all contracts for services, whether intellectual (technical assistance, professional, training, know-how) or related to tangibles such as installation, leasing, etc.

As regards contracts of services for installation of material a distinction must be made between the supply of the service (subject to withholding) and that of material not taxed in Algeria, as for a simple sale FOB.

The withholding base is the gross amount of payments due less a 20% deduction. The gross payment com-

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1. Since 1 January 1984, IREEC replaced the 4% tax rate called "taxe forfaitaire" (Finance Law for 1984, Art. 66).
2. Tax on industrial and commercial profits (BIC):
Tax base: net profit per tax rules (note exclusion of certain charges)
General rate: 50% reduced to 20% for reinvested profits (Finance Law 1986)
3. Tax on industrial and commercial activity (TAIC):
Tax base: gross turnover
Rate: 2.55% (Finance Law of 1984) – deductible for tax on profits
4. Turnover tax on production (TUGP):
Applied to: operation of sale, building, importation and self supply
Tax base: turnover including taxes
Rate: various according to the kind of operation
5. Finance Law for 1984, Art. 55, Direct Tax Code, Art. 80.1.

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prises the remuneration, costs reimbursed or borne by the Algerian customer which would normally be paid by the supplier, the turnover tax on services (TUGPS) and the withholding tax itself. The rate of the withholding tax is 25% (after a 20% reduction on the base, the effective rate is 20%). The Direct Tax Code provides for the payor to operate the withholding at the time of making the payment.

2.2.2 Turnover tax on service (TUGPS)[6]

This tax applies to services performed by foreign firms in Algeria.

The tax base is the gross amount paid, including TUGPS and the withholding tax itself.

The tax is cumulative. It is withheld by the client and paid over to the treasury, if the taxpayer has no establishment in Algeria.

For instance:

Cost of service		500
TUGPS	694.44 x 8%	55.55
Withheld at source:	694.44 x 20%	138.89
Gross amount		694.44

Note the mechanism is similar for computation of IREEC and TUGP.

3. OTHER MAJOR TAXES

In addition, foreign companies active in Algeria have to take into account the following taxes, mainly:

3.1 Taxation on salary (ITS)

An employee is subject to the ITS when he is an Algerian resident or when he performs an activity in Algeria, whether the sum is paid in Algeria or not, and is withheld monthly by the employer.

The taxable income is the gross salary plus fringe benfits of any kind, less deductions of 1,200 DA (1986 Finance Law for 1986). Certain allowances specified in the law are exonerated from tax.

The tax is calculated with reference to a rate-table taking into account the marital status of the taxpayer.

3.2 Payroll tax (VF)[7]

Foreign companies, the same as every employer carrying on an activity in Algeria and paying salaries, are subject to payroll tax.

4. OTHER POSSIBLE FORMS OF FOREIGN BUSINESS ENTERPRISE IN ALGERIA

4.1 The mixed economy company (joint-venture enterprises)

Law 82-13 of 1982 permits Algerian state-owned enterprises to form joint ventures with foreign firms through a protocol agreement subject to approval by interministerial decree. The joint venture is subject to the normal taxation rules applicable to entities established in Algeria.

Certain tax exemptions are offered indirectly to the foreign partner operating through joint ventures.

The most important exemption is from tax on profits during the first three fiscal years, and 50% and 25% abatement of tax payable for the 4th and 5th fiscal years.[8]

In spite of these advantages, this kind of entity has some drawbacks:

- a joint venture is often created to fulfil a predetermined objective within the framework of the general development plan;
- the Algerian shareholding cannot be less than 51%. The foreign partner therefore neither controls, nor directs the joint venture;
- profits are not controllable since prices cannot be fixed in the protocol agreement;
- profitability is not necessarily the prime objective of the Algerian partner;
- the foreign partner has numerous obligations, especially in connection with the transfer of technology;
- administration of the entity is cumbersome and subject to complex regulations.

Law 86-13 of 19 August 1986 modifies the Law of August 1982. It is clear that the new law demonstrates a more liberal approach on behalf of the Algerian authorities. For example, the law aims at easing the conditions that can be inserted into the protocol agreement in favour of the foreign companies.

At the time of writing we await details of its practical application. . .

4.2 Local offices

4.2.1 Definition and use

If foreign companies cannot establish a branch or a subsidiary in Algeria (except a joint-venture enterprise), they may open an office under the circular 09/CAB of 27 March 1982 of the Trade Ministry. According to this circular, the "entity" can be:

- either an office acting within the scope of one or more contracts concluded with the State or a State entity (support office); normally the office must be

6. Turnover tax on services (TUGPS):
Applied to: leases other than that of unfurnished buildings, any operation not subject to TUGP
Tax base: turnover including taxes
General rate: 8%

7. Payroll tax (flat rate payment – versement forfaitaire):
Tax base: fringe benefits and gross salary paid in Algeria or elsewhere (only listed allowances are excluded from the tax base)
Rate: 6%

8. An article on "Joint Venture Enterprises" by Prof. N. Terki was published in the *Bulletin* in January 1985 (p. 35).

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closed down, on expiration of the contract;
- or an office permitting a foreign company without a contract in Algeria to prospect the Algerian market (representative office).

Regulations specify that contracts are only concluded with the foreign company and that the office acts only for and under the responsibility of the foreign company. Consequently, the office cannot be managed by a person with the power to bind the company or to conclude contracts in the company's name.

4.2.2 Tax on local offices

According to an answer from the tax authorities given to a foreign company in 1983, representative offices are not subject to taxes on profits or turnover as long as they do not perform a taxable activity. Nevertheless, the employees of the office are subject to the ITS, and the payroll tax is due from the employer. It was specified in the answer that the registration of an office has no fiscal consequences. It should be noted that the establishment of a representative office involves the payment of registration duty equal ot 10,000 DA (Complementary Finance Law for 1986).

Given the lack of precision in the legislation seems that support offices are subject to the taxes related to salaries paid, the foreign company being subject to taxes upon realization of the contract.

4.2.3 Creation of a local office: conditions and procedure

The creation of an office requires the authorization of the Trade Ministry. The question arises as to whether all offices require authorization. In practice, it could be argued that an office established to support a contract is not subject to authorization. A foreign company having concluded a contract with an Algerian partner should be considered as authorized to work in Algeria and to set up the organization necessary for implementing the contract. Nevertheless, the wording of the 1982 circular states that all offices are subject to the authorization and it is therefore advisable to request it.

Specific conditions must be met in order to obtain the authorization:
- the manager of the office and the foreign company must have the same nationality (Algerian authorities do not stipulate a requirement for residence in Algeria);
- the office must be approved by the Ministry responsible for the Algerian entity which concluded the contract with the foreign company. In fact, a foreign company may apply for authorization of an office prior to concluding a contract (circular of 1982);
- the foreign company must be a legal entity (which excludes groups not forming legal entities in their own country);
- the foreign company must not have defaulted in executing a contract in Algeria. The foreign company must not be in bankruptcy or liquidation.

In addition, the foreign company has to assemble a file and apply for enrolment at the trade register.

4.3 Warehouses under customs control (Magasins centraux d'approvisionnement(MCA))

Finally, it is important to note a special form of business which consists in supplying the Algerian market with "spare parts" through a general warehouse subject to specific customs regulations (Finance Law for 1985). The warehouse is set up by contract between a foreign company and an Algerian state enterprise, an interministerial decision determines which of the parties will be responsible for running it. In any case, the foreign company is responsible for supplying materials, placing qualified personel at the disposal of the warehouse and transferring its management know-how (Decree of 14 August 1985).

Given the lack of precision of the legislation, important specified organizational details such as payment to the foreign suppliers must be specified in the contract.

Concerning the taxes applied to the MCA, the complementary Finance Law 85-06 for 1985 states that the warehouse is exempted from tax on profit, tax on commercial and industrial activity and payroll tax; moreover, salaries paid to the foreign employee of the MCA are not subject to the ITS (tax on salary). The only tax due seems to be the TUGP on sales.

5. INTERNATIONAL TAX ASPECTS

5.1 Situation of French companies operating in Algeria

Their situation is special as long as the 1982 tax treaty between Algeria and France applies.[9]

5.1.1 Construction firms

French companies with construction sites of whatever duration in Algeria are considered to have a permanent establishment under the terms of the treaty and are in principle subject to normal Algerian tax laws. The treaty expressly provides that such companies can opt for the IREEC.

So far French companies have taken advantage of this option, the IREEC being perceived as lighter than the normal taxes.

However, the 1984 Finance Law increased the accounting and reporting requirements for foreign companies under the IREEC, the rate of which was raised by the 1985 Finance Law; moreover, the normal tax on profit rate has been reduced by the 1986 Finance Law. There could be grounds for reviewing the benefit of the option in every case.

9. Under the provision of the tax treaty itself, it normally applies to the Algerian tax such as modified by the 1984 finance law.

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5.1.2 Contract for provision of services

Concerning the withholding tax applied to a contract for services, no option is specified in the treaty. Normally, the French company having a permanent establishment under the terms of the treaty should be subject to normal rules on the taxation on profits.

However, although an activity might constitute a permanent establishment under the treaty, it might not be seen as a permanent "installation" within the meaning of Algerian law, and as such be subject to the withholding tax and not BIC and TAIC.

In practice, the withholding tax seems to be invariably applied.

5.2 Algerian tax as tax credit

The tax treaty signed between France and Algeria contains provisions to avoid double taxation.

For example, the share of IREEC in connection with provision of a service whose profit is taxed in France (especially services used in Algeria, but performed in France) is deductible from this profit.

In the same way, the tax credit method is used in certain cases. For a company established in a country without a treaty with Algeria, considering Algerian tax as a tax credit can cause problems because of the special characteristics of the Algerian withholding taxes. For example, a foreign tax may be considered as a tax credit for U.S. tax purposes only if it is, among other conditions, an income tax or a tax in lieu of an income tax under U.S. law. It is by no means certain that the IREEC satisfies these conditions since it is a tax that replaces a turnover tax (TAIC) as well as the profit tax (BIC).

The problem is solved when the tax authorities list the foreign taxes which may be credited against profit tax. For example, German tax authorities have explicitly listed the IREEC and the taxes applied to foreign companies without permanent installation in Algeria as creditable foreign tax.

A detailed outline of the tax system in Algeria is available in French and English in the Bureau's loose-leaf services African Tax Systems or Systèmes Fiscaux Africains.

Contact the Bureau for further details.

MID-ATLANTIC COMMITTEE

On 3 February 1987 the International Fiscal Association Mid-Atlantic Committee held a seminar in Philadelphia. The following subjects were on the program:

Foreign currency transactions and new subpart F rules, Robert J.E. Henrey, CPA Coopers and Lybrand, New York, NY.

New Branch Tax rules and repeal of general utilities, Charles I. Kingson, Esq., Wilkie Farr & Gallagher, New York, NY.

New foreign tax credit limitation rules and allocation of expenses, Richard A. Gordon, CPA Arthur Andersen, Washington, D.C.

Internal revenue service intercompany pricing project, Speaker: Charles S. Triplett, Esq., Deputy Associate Chief Counsel (International), Internal Revenue Service, Washington, D.C.

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Unitary Taxation and General International Law

By A.H. Qureshi*

INTRODUCTION

Unitary taxation in the international sphere raises questions of International Law – yet, interestingly, there is relatively little direct academic consideration from a General International Law perspective; nor does it seem to have been invoked seriously in the orchestra of protests by states against its use in the U.S.A.[1] This disservice to International Law may in part be explained by the fact that tax lawyers are often removed from International Law and are more concerned with pragmatic considerations, rather than the finer points of validity under International Law.

The international issues generated by the application of unitary taxation are primarily two-pronged – but essentially jurisdictional. First, the question posed is whether a state can, under International Law when imposing taxation, disregard the corporate veil of the resident company and treat its world-wide affiliates as being an integral part of the resident company in the computation of the profits. Second, and related, given the potential extra-territorial reach of unitary taxation to profits arising from outside the state does the unitary method constitute a violation of International Law. Conjunctively, the issue that arises is whether unitary taxation, as a method of apportioning company profits to a corporate entity within the tax jurisdiction, is a valid process of taxation. This issue will be considered from a General International Law perspective (i.e. Customary International Law and General Principles of Law recognized by civilized nations).[1a]

In this article it is proposed primarily to highlight some of the issues that may arise from unitary taxation in the context of General International Law. This is done against the background of the unitary taxation debate vis-à-vis the U.S.A.

Dr. Qureshi is a lecturer in Fiscal Law at the University of Manchester. He completed LL.B. at the University of London in 1977. Thereafter, Dr. Qureshi completed an M.A. in Business Law at the City of London Polytechnic in 1980, an LL.M. at the London School of Economics in 1981 and received his Ph.D. from the London School of Economics in 1985. He is presently engaged in preparing a series of articles.

UNITARY TAXATION – THE CONCEPT

Shrouded as it is in a rather esoteric realm – the task of unveiling the concept is no simple effort. It is not intended here to enter into an exhaustive description – nor to evaluate the intrinsic merits of the concept – but merely to consider those features that are pertinent to this analysis.

First, unitary taxation[2] is not a tax as such, but rather a *method* of calculating profits or defining the tax base, for the purposes of computing corporate tax liability of a resident company that is multi-jurisdictional in character. Such a company is an integral part of a group of companies situated in different territorial jurisdictions, and is, it is assumed, properly within the state's tax jurisdiction in the first instance. This tax jurisdiction arises normally because of the residence of the company within the state as a result of being incorporated in the state and/or "operating" within the state.

Second, the state in the computation of the profits to be taxed unveils the corporate entity so as to conceive the company as an integral component of the group of companies to which it is affiliated. In other words the group of affiliated companies situated variously outside the jurisdiction are treated as one unit in the process of ascertaining the profits of the company within the jurisdiction.

* I am grateful to Dr. A.V. Lowe of the University of Manchester for his assistance. This article is not intended to be an exhaustive analysis of the subject although some conclusions are nevertheless tendered.

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This is to be contrasted with the other main method of apportioning the profits of a multi-jurisdictional company, the separate accounting method. This is the more prevalent international practice. Under the separate accounting method the profits of the company within the jurisdiction are computed in full recognition of its separate and independent legal character. Only the actual profits of the company in question are of concern.

Third, under the unitary method it must be possible to conceive of the group of companies as a single unit. There must be a *unitary business.* However, there is no universally accepted criterion to determine what constitutes a unitary business, save that embodied in the unitary concept is the relationship of "dependency and contribution between the portions of the business within and without the taxing state".[3] The following considerations are normally taken into account as indicators of the dependency relationship:[4]

1. common ownership born out by the percentage of voting stock owned;
2. centralized performance of services, e.g. accounting, advertising, etc.; and
3. centralized executive force and general method of operation.

It will be noted that the question whether there is a unitary business is substantially one of fact.

Fourth, only a proportionate part of the total profits of the whole conglomerate is attributed to the company within the jurisdiction. The profits are apportioned on the basis of the *contribution* made to the whole enterprise by the company within the jurisdiction.

There is no standard technique employed in measuring the contribution made to the total enterprise profits as a whole by the company within the jurisdiction. In the U.S.A. the formula generally used by states is based on three factors, i.e. the payroll, property and sales receipts within the state. The formula is usually expressed thus:[5]

$$\left(\frac{Ps}{Pt} + \frac{Rs}{Rt} + \frac{Ss}{St}\right) \times It = Is$$

where Ps = In-state property
Pt = Total property
Rs = In-state payroll
Rt = Total payroll
Ss = In-state sales
St = Total sales
It = Total corporate income
Is = Income taxable by the state

Finally, whatever the intrinsic appeal of the unitary concept, a characteristic *result* of its operation is that unitary taxation may act to "incorporate" profits arising outside the territorial jurisdiction to corporations operating extra-territorially. There is no relief available for the foreign tax paid on this "incorporated" profit. In the separate accounting method the profit arising outside the territory may be "incorporated", but only those of the company within the jurisdiction, and allowance is made for double taxation.

The "incorporation" arises in the following manner. First, because the unitary method is based on contribution made to the overall profits of the unit (expressed as a percentage of the total profits), the profits attributed to the company within the jurisdiction are not necessarily the profits actually arising within the state territory. Second, the factors used to measure the contribution may not in fact do so reasonably and/or accurately. Third, the monetary value of the factors (i.e. the property, sale receipts and payroll) which are assumed to contribute to the total profits of the unit vary significantly in different jurisdictions. Thus property value and wage rates are generally lower in countries other than the U.S.A. These countries would therefore have a lower attribution of profits.

Some of the profits incorporated arising extra-territorially are not a consequence of any inherent flaw in the unitary concept as such, but arise from particular applications of the concept. Thus, appropriate selection of factors to reasonably reflect contribution and some form of indexation or similar mechanism to alleviate disparities in monetary values could be apposite.

AN EMPIRICAL ACCOUNT

Unitary taxation is not a modern day phenomenon peculiar to the U.S.A. In fact, a study by the Fiscal Committee of the League of Nations[6] in 1933 documented the use of unitary taxation as a primary method in Spain, Switzerland, Austria, Czechoslova-

1. Although treaty provisions have been invoked e.g. F.C.N. Treaties have been relied upon in U.S. Courts against U.S. authorities (see e.g. *Virginia Journal of International Law* Vol. 26(1), page 102) and some reliance is also made of General International Law (see e.g. Alcan Aluminum Limited v. the Franchise Tax Board of the State of California. In the United States District Court for the Northern District of Illinois. Eastern Division. Civil Action No. 84-c-6932. (1) In the Brief Amicus Curiae of the United States it is stated: "the Federal Executive has concluded that the 'arm's length' method of allocating income to instrumentalities of foreign commerce is the *international norm and custom* adopted by all developed foreign nations and that the Secretary of State has taken the position in the conduct of foreign affairs and has agreed with foreign nations that this is the proper method of taxing such instrumentalities." [Italics added.] (2) Brief Amicus Curiae filed on behalf of the European Economic Community and the Governments of Australia, Japan and Switzerland where it is stated: Moreover world-wide income is combined without regard to whether such income is taxable under the Internal Revenue Code or applicable treaty, and without regard to the fact that income has been attributed to and taxed in foreign jurisdictions in *accordance with international law).* [Italics added.]

1a. The role of regional Customary International Law has not been considered here.

2. Also described as fractional apportionment, formula apportionment and the 'indirect' method.

3. *Report to the Chairman, House Committee on Ways and Means of the United States* – Key Issues affecting state taxation of multi-jurisdictional corporate income need resolving. G.A.O./GGD-82-38. 1 July 1982 at Page 29. See also Edison California Stores Inc. v. Mc Colgan, 30 Cal.2d. 472,183 P2d.16 (1947).

4. Ibid.

5. Ibid. Page 3.

6. League of Nations. *Taxation of foreign and national enterprises.* Geneva. 1932. Vol. 11. Page 60.

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kia, Hungary and of course some states in the U.S.A.[7] In addition other states, e.g. France,[8] Germany and even the United Kingdom[9] resorted to a method or form of fractional apportionment in limited and defined circumstances.

The Fiscal Committee of the League of Nations, however, recommended the use of separate accounting as a primary method in one of the earliest drafts of a multilateral tax convention, and this stand was also reflected in the draft model for bilateral tax conventions in 1935.[10] The unitary method was to be allowed only as a secondary measure and only to the extent that a substantially similar result was to ensue as would if the separate accounting method was used.

The League of Nations further continued its work with the conclusion of the London and Mexico Model Conventions.[11] These again, whilst advocating the use of separate accounting as a primary method, allowed for the use of the unitary method as a secondary measure provided the result was not substantially at variance with that arrived at from the separate accounting method.

Following the League of Nations, the OECD made its mark in this sphere with the OECD Model Double Taxation Convention of 1977. In Article 7, along the lines of the League of Nations, the use of the separate accounting method is advocated as the primary method, and the use of the unitary method only insofar as it has been customary[12] in the Contracting State and again only to the extent that the result is not substantially at variance with the separate accounting method.

Recently, the U.N. Group of Experts in their 1980 Model Treaty between developed and developing countries in Art. 7 endorsed the OECD thinking on the unitary method.

Insofar as the actual practice of states is concerned with regard to bilateral agreements, a U.N. report[13] concludes that most of the treaties between industrialized countries incorporate the provisions of the OECD Model Convention or are along its lines – allowing for the use of the unitary method only in some cases. Treaties between industrialized and developing countries follow a similar pattern although the practice of allowing for the use of the unitary method is comparatively even less frequent.

As is apparent, because of the extra-territorial effect of the unitary method, the use of the method has evoked considerable discussion. Of late, however, it has been a source of much consternation for multi-jurisdictional corporations operating through subsidiaries in the U.S.A. The unitary method as applied to corporations operating within the U.S.A. is fairly prevalent – approximately 45 states use it. But more importantly in the international context some states – particularly California, Montana, Alaska and North Dakota – use the unitary method in apportioning the world-wide profits of multi-jurisdictional corporations.[14]

Many foreign governments have challenged the U.S. Government on the use of the unitary method by U.S. states and have called for Federal legislation to be introduced to restrict the practice at the "water's edge", i.e. to taxation confined to income derived from the territory of the United States. No Federal legislation has to date been passed by the U.S. legislature although in late December 1985 the Reagan Administration sent legislation to Congress to restrict the use of unitary taxation.[14a] It is believed[15] that the President's proposals are not likely to meet smooth success. Indeed, one Senator claims: "the proposal is a

7. Ibid. At page 60 it is stated: "182. In short fractional apportionment may be considered a primary or basic method in Spain, in Switzerland (as regards the practice of the principal Cantons), in Austria, Czechoslovakia and Hungary (under the treaties described) and in various states in the United States. France uses it in determining the quota of dividends and interest distributed by a foreign corporation which is subject to the tax on income from securities. Otherwise fractional apportionment is a secondary method, being employed only when assessment on the basis of separate accounting, subject to verification, or various empirical methods are considered inadequate. Such is the case in France with regard to the commercial profits tax, and in Germany."

8. Ibid. Paragraph 211. It is stated: "The system of fractional apportionment is also regularly employed by France in the imposition on foreign companies of its tax on income from securities. . . The reason for this imposition is that French companies are required to withhold at source a tax on dividend and interest payments, in addition to the tax assessed on its industrial and commercial profits as such. To place a foreign company exploiting property in a similar situation, and to reach that part of its distributed income which is deemed to have been derived from French sources, the foreign company is required to pay this tax on the same proportion of the dividends distributed or interest paid at its seat abroad as its assets in France bear to its total assets."

9. Ibid. At page 71 it is stated: "239. Not infrequently, when the local accounts of a foreign enterprise are insufficient for the determination of income, the British India Income-Tax officer has recourse to a method of fractional apportionment provided in Rule 33 of the Income-Tax Rules. This Rule provides, inter alia, that in any case in which the income-tax officer is of the opinion that the actual amount of the income, profits and gains, accruing or arising to any person residing out of British India, whether directly or indirectly, through or from any business connection in British India, cannot be ascertained, the amount of such income may be calculated on an amount which bears the same proportion to the total profits of the business of such persons (such profits being computed in accordance with the provisions of the Indian Income-Tax Act) as the receipt so accruing or arising bear to the total receipts of the business. . . 240. Similarly in the law of the United Kingdom, there is no provision for fractional apportionment, but it may be employed as a last resort in some cases when the method of separate accounting or of taxing on a basis of a percentage of turnover fail to yield satisfactory results. For example, tax collectors have considered assessing the local profits of foreign banks by applying to the total net profits the ratio of assets in the United Kingdom to the total assets. Belgium and Luxembourg also use this method when others fail."

10. League of Nations document. C.252.M124.1935 11 A: annex to Fiscal Committee report of 1935.

11. League of Nations. Fiscal Committee, London and Mexico Model Tax Conventions – Commentary and Text (Geneva, 1946), P.20.

12. See Sun Life Assurance Co of Canada v. Pearson (Insp. of Taxes) 1984 STC Chd Page 481 at Page 514 on meaning of customary. Vinellott, J. states that the word customary is used to "describe a basis of taxation in force in a particular jurisdiction at a time when a double taxation treaty in the form of the model treaty is entered into. . ."

13. Tax Treaties between developed and developing countries. U.N. Second Report. E/49 36/ST/ECA/137.

14. *Tax News Service*. Vol. 20. International Bureau Of Fiscal Documentation. Page 123. As of 5 September 1986, in California new legislation has been introduced limiting the use of the unitary method to the Water's edge at the option of the taxpayer. The legislation becomes effective as of January 1988.

14a. Proposed Federal Legislation (S.1974). See *Bulletin International Fiscal Documentation*. Aug./Sept. 1986 at page 375.

15. Mertens – *Law of Federal Income Taxation* January 86. Page 31.

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direct result of foreign pressure and intimidation. The President is sacrificing an important state power to quiet a noisy ally".[16]

THE LEGAL TERRAIN

In considering the nature of the case against the states[17] in the current debate on unitary taxation as evidenced in the diplomatic addresses[18] to the U.S., the arguments used against the states ought to be viewed against the background of the rhetoric and the vested interests that cloud them. With that in mind, the following are some of the major concerns expressed.

International norm militating against the use of the unitary method qua method

First, there is discernable in the wave of protests addressed to the U.S.A.[19] a veiled suggestion that there is in fact an international norm that militates against the use of the unitary method as such. This suggestion is couched first in the form of a suggestion of an international agreement in favour of the use of the separate accounting method. Thus the U.K. Government[20] asserted in its statement to the U.S. Treasury Working Group on Worldwide Unitary Taxation:

> 4. The unitary method of taxation is wholly contrary to the agreed international method of attributing the profits of multinational enterprises between the countries in which they operate. This is the arm's length method. . .
>
> 5. Unitary taxation is incompatible with this internationally agreed method. . . over the last 40 years or more the international community has devised and refined the arm's length method for international use. It is in this context of world-wide agreement about the method of attributing profits to multinational companies that the use of a different method by some states of the United States causes a distortion which makes it internationally unacceptable.

Although it is accepted that the international agreement that is alluded to does not refer to a treaty, it needs nevertheless to be stated at the outset, given that such a suggestion may be construed (and may be intended to be construed), that there is no international agreement as such. There is no multilateral treaty nor any statement emanating from an authoritative norm creating organ of an international organization. The Model Conventions like the OECD 1977 Double Taxation Convention cannot be conceived of as being prescriptive. The work of the League of Nations, OECD and the U.N. in this field have all fallen short of actually prescribing by way of an operative multilateral treaty a particular method of apportioning company profits. The works in fact form merely optional pointers based on an evaluation of the intrinsic merits of the unitary and separate accounting methods set against state practice. The Model Conventions are only suggested[21] solutions.

Further, the evidence is not conclusive as to a consensus on the part of states on the appropriateness of the use of the separate accounting method as such. Thus, the League of Nations in the end only managed to draft a model convention rather than a multilateral treaty. Similarly, the devise of a model convention rather than a multilateral treaty tendered by the U.N. and OECD is arguably suggestive of the fact that states have not agreed to the appropriateness of the separate accounting method. The international community (as distinct from groups of tax experts) has not had the opportunity to address in an international forum candidly the question whether the unitary method or the separate accounting method is the right method – with the added knowledge that the offering of an opinion on the merits may carry legal significance.

In addition, whilst there is apparently a dominant practice of states in using the separate accounting method that may be indicative of a consensus, the reasons for this practice are not in fact clear. Some light is shed by the League of Nations. It is stated:

> Whatever requirements exist were for the most part formulated from the stand point of national enterprises carrying on their business within the country. . .[22]

Thus, the practice of states with regard to the separate accounting method in relation to foreign subsidiaries is not necessarily a fully considered practice based on the intrinsic merits of the method. State practice does not therefore necessarily reflect consensus on the use of the separate accounting method vis-à-vis foreign companies.

Second, the assertion that there is in fact an internationally agreed practice[23] of apportioning company profits is misleading insofar as it contains a nuance of Customary International Law. The suggestion is not in fact borne out. There is no Customary International Law norm (nor for that matter any General Principle

16. Ibid. Senator. Max Baucus, D. Mont.

17. The U.S. government itself in addition to enacting Federal legislation has filed an Amicus Curiae in its own courts in the Alcan Aluminum case (see footnote 1 above) against the application of the unitary method. It asserts there: "It is the clearly expressed policy of the United States that the separate accounting or 'arm's length' method is the appropriate method of allocating income among commonly controlled multinational corporations. This view has been adopted in the United States Internal Revenue Code and is a provision of virtually all bilateral tax treaties that have been entered into by the United States. The 'arm's length' accounting method is the system for computing income among multinational corporations adopted by the United Nations and by most foreign taxing authorities and it is specified in the model income tax treaties published by the Organisation for Economic Cooperation and Development (OECD) and the United Nations. . . State application of the world wide unitary method of taxation conflicts directly with this federal policy and international standard."

18. See Footnote 54 at page 101 of *Virginia Journal of International Law* 1985. Vol. 26:1 for references of Diplomatic Notes of various countries addressed to the U.S.

19. As well as in the U.S. Federal view. See footnote 17 above.

20. Statement published in 1984 in *International Bureau of Fiscal Documentation* at Page 157.

21. See e.g. U.N. Draft Model Taxation Convention I.F.A. 1979. 33rd Congress at Page 58 where it is stated: "Like all model conventions, the United Nations Model Convention is not enforceable. Its provisions are not binding and furthermore should not be construed as formal recommendations of the U.N. . ."

22. Op. cit. supra note 6 at page 40.

23. Op. cit. supra note 20 at page 157 it is stated "The world-wide unitary method of state taxation is contrary to well established international principles and practice of taxation. . ."

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of Law recognized by civilized nations) that proscribes the use of the unitary method and/or prescribes the use of the separate accounting method. This is for the following reasons.

First, the task of defining the tax base, as much as imposing the rate of tax is an activity prima facie[24] essentially within the state's domestic jurisdiction[25] – particularly when it focuses on a domestic company.

Second, there may well be a substantial international practice of using the separate accounting method, but there are also states (other than the U.S.A.) which have used the unitary method as a primary method in the very recent past.[26] The unitary concept is also still used, albeit sometimes in disguised form, in defined[27] circumstances – and the option to use it is allowed for in the model tax conventions.[28]

In addition, the practice may not in fact be as substantial as asserted given the fact that the U.S.A., a major economic power which commands a comparatively significant commercial intercourse with other states, is not a party to this practice.[29]

Third, the practice of using the unitary method in the U.S.A. has been for some time – and along with it economic relations with foreign governments. Yet the U.K. along with European governments and Japan started their diplomatic protests only comparatively recently – since about 1979.[30] This time dimension would suggest more a desire for change in practice and law as distinct from the existence of an actual legal position.

Fourth, the practice of the use of the separate accounting method does not originate on the whole from state practice as such – but rather from the *practice of corporations* in computing their profits by way of the separate accounting method. Thus, there is nothing in U.K. tax law which specifically prescribes the use of the separate accounting method or proscribes the computation by the corporation of its profits by way of the unitary method as long as the profits so assessed do not fall short of the profits by way of the separate accounting method. In fact, if it can be referred to as state practice – it is state practice in relation to the use of the separate accounting method that is on the whole characterized by omission. The inactivity on the part of the state is in relation to the computation of profits by corporations using the more favourable separate accounting method.[31] As such, there is no specific state practice with regard to the use of the separate accounting method.[32] Indeed, national provisions regulating transfer pricing (i.e. the prices used in transactions between parent and subsidiary) to an "arm's length price" may be seen not so much as reinforcing the underlying principles of the separate accounting method, but rather as measures which have more of an affinity with the unitary method of taxation.

Finally, but significantly, states, in their use of the separate accounting method, use it as a convenient method based on their perception of its merits and not as an accepted legal prescription.[33] As has been indicated the use of the separate accounting method vis-à-vis foreign subsidiaries derives primarily from inertia. States have almost mechanically extended the methodology used in relation to local companies to foreign subsidiaries.

Further, the very fact that there are provisions in model tax conventions and bilateral treaties deliberating on the matter is indicative of the absence of a rule of Customary International Law. Indeed it is suggested that the view that there is no opinio juris is shared by the states opposed to unitary taxation themselves. This is evident from the muted manner in which General International Law has been invoked, if at all, in the diplomatic protests addressed to the U.S.A.

Unitary method operates extra-territorially and therefore is contrary to International Law

It is contended that the unitary method of taxation operates in fact extra-territorially. In other words, the

24. Brownlie. *Principles of Public International Law.* Third Edition at page 293: ". . .if a matter is prima facie within the reserved domain because of its nature and the issue presented in the normal case, then certain presumptions against any restrictions on that domain may be created."
25. See F.A. Mann, *Studies in International Law* 1975 at page 99. "No problem of international jurisdiction occurs, because the domestic legislation is concerned solely with measuring the domestic taxpayer's tax liability."
26. See footnote 5 above.
27. E.g. (1) see provisions of the U.K. Finance Act 1984 Sections 82-91, and Schedule 16 on Controlled foreign Companies. Similar provisions exist in U.S.A. (Internal Revenue Code), Germany (Aussensteuergesetz AStG), Canada (Sections 90-95 of the Canadian Income Tax Act 1972) and France (Art. 18 of the Finance Act 1973) which attribute income of foreign based corporations to domestic shareholders). (2) In Germany, until 1972 a foreign subsidiary economically integrated with its German parent was deemed to be a resident German company for tax purposes according to Art. 15(2) of the Law for the Adaptation of Taxes of 1934. See Frommel *Taxation of subsidiaries,* at page 60. (3) In Switzerland, Taxable income of a branch (as opposed to a subsidiary) is determined by the indirect method. In Spain, where branches are concerned a 15% tax is charged (unless excluded by treaty) on the dividends distributed by a non-resident company to the extent that they are deemed to be paid out of profits derived through the Spanish branch. See Frommel *Taxation of subsidiaries,* at Pages 83 and 85.
28. See supra, Empirical account.
29. See North Sea Continental Shelf Cases (*ICJ* Rep. 1969, P3 at Page 42) where it was pointed out that the practice of states specially affected was of particular relevance.
30. Op. cit. supra note 20.
31. This evaluation is certainly born out by the League of Nations study (see op. cit. supra, note 6) and there is no reason to suppose that this situation has significantly changed since. It is stated at page 40: "102. Although the fiscal or commercial laws of the various countries may presuppose an accounting which reflects a proper allocation of income for tax purposes, they have not yet prescribed any definite criteria.
106. . . In no country does the fiscal law prescribe any particular method of accounting, although some laws specify in detail allowable deductions and methods of evaluating assets, or fixing allowances for depreciation."
32. Brownlie op. cit. supra note 24 at page 6 it is stated: ". . . it is the actions of states which build up practice." See also Fitzmaurice. 30 *BYIL* (1953), 67-68.
33. Article 38 of ICJ ". . . general practice *accepted* as law." [Italics added.] Thus, for example the U.S. government takes the view that it does (see footnote 1 above) as a matter of its foreign policy and not as a matter of legal obligation although it does somewhat confusingly use the expression "international norm" (see footnote 1 above). See also Frommel. *Taxation of subsidiaries* at Page 61, where he mentions the German Schering case in which it was held that the taxation of the world-wide income of a company that is both incorporated and managed abroad was not against the principles of international law.

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unitary method functions as a means of incorporating foreign profits[34] of a foreign entity rather than merely as a *method* of defining the tax base of the subsidiary. As such it is considered to be contrary to International Law.

Thus, the Japan Federation of Economic Organization (Keidanren) in their submissions to the U.S. Government stated:

> In practice, the world-wide unitary tax method imposes tax on the foreign-source income of entities residing outside the state and even outside the United States by combining the income of all corporations in the group to which the resident corporation belongs and apportioning it to each geographical area. This constitutes the extra-territorial application of law. . .[35]

The Netherlands State Secretary for Finance is more explicit. He states:[36]

> Unitary taxation amounts to extra-territorial taxation and legislation and is as such in contravention of International Law.

In effect, what is being asserted is that the principle of International Law affirming state sovereignty is being undermined by the use of the unitary method. This contention may be perceived in a two-tiered manner. First, that the U.S.A. does not have the requisite fiscal legislative jurisdiction to impose what amounts to tax liability on a foreign entity without any direct or substantial connection with the taxing state. Second, that the state cannot enforce its tax jurisdiction extra-territorially by the unitary method.

First, in the context of legislative fiscal jurisdiction, the position under International Law is not clear. On the one hand it is contended that the international fiscal regime is characterized at the level of General International Law with few restraints. In particular, the position under International Law is that a state's legislative fiscal jurisdiction is unfettered.[37] The international fiscal order is characterized by the absence of a norm which limits taxation territorially.[37a] In fact, extra-territoriality is a characteristic feature of international taxation.

Given this view there is no question of improper legislative fiscal jurisdiction being exercised even if the substance of the legislation (as opposed to the form) was considered. Plainly, the legislative form is addressed to a national subsidiary and hence no question of improper jurisdiction arises in a formal context.

In the opposed view,[37b] it is contended that fiscal legislative jurisdiction is subject to the requirement of a reasonable connection between the foreign parent and the taxing state particularly where the legislation is very likely to be enforced.

With respect to this opposed view, in so far as the foreign profits earned abroad are reasonably attributable to the subsidiary, it is asserted, first (and this will be amplified further in the context of enforcement jurisdiction) that there is in fact a reasonable or substantial connection with the taxing state. The parent company by reason of the unitary character of the conglomerate is present within the state. The parent company also is present as a shareholder[38] and has a connection by reason of its interest in the company as a shareholder.[39] In addition, there is a reasonable connection with the taxing state by reason of the very fact that the profits are attributable (or connected) to the subsidiary company resident within the taxing state. Second, the charge of invalid exercise of legislative jurisdiction may only be seriously maintained when unitary taxation operates in fact (or is likely to do so frequently) in an improper extra-territorial fashion. The nature of the potential extra-territorial character of the unitary method, since it operates in this manner only sometimes in the foreign context,[39a] is not a basis in itself for characterizing the unitary legislation as being an invalid exercise of state legislative fiscal jurisdiction.[40]

Second with regard to the enforcement of tax jurisdiction – the general rule under International Law is that enforcement jurisdiction is territorial.[41] Thus, the critical question posed, in the first instance, by the unitary method is whether the foreign parent corporation is within the state's territorial jurisdiction for the purposes of enforcement.

It has already been asserted that the parent company is within the territory inter alia by reason of the unitary character of the enterprise. However, this assertion in particular invites a consideration of the position under International Law of the circumstances in which the corporate veil may be lifted.

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34. See also reference to Carlson in Canadian Amicus Curiae filed in Alcan Aluminum case (op. cit. supra footnote 1). He states in State taxation of corporate income from foreign sources, in *Essays in International Taxation*, 1976 at page 264 "combining the parent and its other subsidiaries with the California subsidiary can be viewed as taxing enterprises that have no permanent establishment in the U.S."

35. *International Bureau of Fiscal Documentation* 1984 at page 255 see also op. cit. supra note 20 at page 157 and Amicus Curiae filed by Canada in the Alcan Aluminum case (see footnote 1 above) where it is stated: "It is taxing the income of entities with which it has no jurisdictional link whatsoever."

36. *International Bureau of Fiscal Documentation*. 1984 at page 295.

37. See for e.g. (1) A. Knechtle, *Basic Problems in International Fiscal Law* 1977 at Page 37. (2) H. Wurzel, "Foreign investment and extra-territorial taxation." *Columbia Law Review* 1938 Vol. XXXVIII at Page 814. (3) Martin Norr, "Jurisdiction to tax and International Income" *T.L.R.* 1962 page 431.

37a. See infra note 50.

37b. See e.g. (1) M. Akehurst "Jurisdiction in International Law". *BYIL* 1972-73. Page 179. (2) F. Mann "The Doctrine of International Jurisdiction Revisited After Twenty Years." *Rec Des Cours*, 1984 (111) at Page 29. (3) Paragraph 411 of the 1981 *Tentative Draft No. 2 of the Revised Foreign Relations Law of the United States*. (4) A.R. Albrecht. "The taxation of aliens under International law" *BYIL* 1952 page 145.

38. William Park at page 145 in *Extra-territorial application of laws and responses thereto*. Edited by Professor C.J. Olmstead. He states: "when the parent sets up a foreign subsidiary, it has a presence in the foreign country as a share holder,. . ."

39. The situs of a share is for tax purposes situated in the state of the residence of the company. *ILR* OCT 42 at page 409.

39a. See below for circumstances in which it may operate improperly extra-territorially.

40. Mann, F. *Studies in International Law* 1973 at page 7 it is stated ". . . so long as a State merely introduces a legal rule without taking or threatening steps to enforce it, foreign States and their nationals are not necessarily affected."

41. S.S. "Lotus" *PCIJ Series* A No. 10, 1927, 18-19.

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The lifting of the corporate veil is not absolutely prohibited under International Law. First, a state as an exercise of its sovereignty may disregard its own created legal entity where there is no foreign involvement, as and when it pleases.[42] Second, where there is foreign involvement[43] by way of investment in the country the corporate veil may be pierced first, in the circumstances where it is pierced in domestic practice[44] and second in any other circumstances in spite of foreign involvement, provided that in doing so no obligation towards another state under International Law is being violated. As a corollary to this the corporate veil may also be pierced where there are overriding national interests.[45]

These are the principles enunciated in the Barcelona Traction[46] judgement. The case is not, it is suggested, authority for the rather wide proposition attributed to it by Mann, that as a matter of International Law parent and subsidiary are each subject to the exclusive jurisdiction of their respective sovereigns.[47]

In the fiscal sphere, although the separate legal personality of corporations is recognized, generally the corporate veil is nevertheless lifted in municipal practice to prevent avoidance/evasion, and in the computation of company profits.[48] Thus, the unitary method qua method (i.e. as a method of apportioning profits), involving the lifting of the corporate veil, is acceptable.

Where the unitary method operates to incorporate foreign profits within the jurisdiction (that is profits arising outside the territory to the foreign entities but attributable to the subsidiary by way of its contribution towards the earning of those profits), it is suggested, given that in International Fiscal Law corporate jurisdictional boundaries have not properly been delineated,[49] no territorial principles firmly established,[50] and no obligation under General International Law to avoid double taxation[51] exists – there is no obligation towards another state under International Law strictly in the fiscal sphere that would seem to be violated by the lifting of the corporate veil.

Further, there is neither any question of the violation of another state's sovereignty under International Law since the state is laying a claim to the profits that are in fact attributable to its subsidiary. In addition, in any event, the principle of state sovereignty as a principle of International Law is not a panacea for all inter-state conflicts, and is subject to the limitations imposed by the existing rules of General International Law. Hence, a jurisdictional claim over territorium nullius by a state before others would not violate other nations' sovereignty under International Law although the principle of state sovereignty (and its corollary equality of states) is in fact undermined.

In these circumstances, the lifting of the corporate veil in fiscal matters may be a legitimate instrument of establishing fiscal jurisdiction, although as a general instrument of extending jurisdiction per se it may not necessarily be so. There is no violation of the principle of state sovereignty under International Law. Further, as an addendum it needs to be stated here that in any event the Barcelona Traction case does not assist the parent company qua shareholder or director of the subsidiary in the unitary state.[52]

The next critical question in the context of enforcement is, given the connections with the state either by reason of the lifting of the corporate veil or, and related, by the presence of the affiliates as investors or shareholders – is there any rule of General International Law regulating the measure of enforcement?

Again, the position under International Law is not clear. There are two views. On the one hand, in corporate fiscal matters International Law does not regulate the measure of force when the enforcement is being exercised intra-territorially – apart from some very rudimentary measures.[53] On the other hand, it is maintained that there must be a measure of correlation between the nature of the "connection" and the degree of enforcement.[54]

Assuming this latter view to have force (insofar as the foreign profits arising abroad are attributable to the subsidiary) there is in fact a substantial connection that the parent company has with the taxing state, as has been pointed out. To that is to be added the follow-

42. See e.g. Greig *International Law* at page 397 where he states "the existence of a corporation and the rights and duties established by its constitutional documents – are the creation of the legal system of the place of incorporation. That system alone governs the continued existence of the corporation and its eventual dissolution."
43. Barcelona Traction case. *ICJ Reports* 1970 in Para. 33 it is stated: "when a state admits into its territory foreign investments or foreign nationals, whether natural or juristic persons, it is bound to extend to them the protection of the law and assumes obligations concerning the treatment to be afforded them."
44. Ibid. para. 58 it is stated: "The wealth of practice already accumulated on the subject in municipal law indicates that the veil is lifted, for instance, to prevent the misuse of the privileges of legal personality, as in certain cases of fraud or malfeasance, to protect third persons such as a creditor or purchases or to prevent the evasion of legal requirements or of obligations." See also F. Mann Rec. des Cours. 1984 Vol. 111 at page 63.
45. Op. cit. supra note 42 at page 398 "One situation in which international law would appear to recognise this 'lifting of the corporate veil' is in connection with the customary rule that in time of war a state is entitled to declare illegal all transactions entered into with an enemy national or corporation."
46. Op cit. supra, note 43.
47. Mann, F. *Rec. Des. Cours.* 1984. Vol. 111 at page 56.
48. Op. cit. supra, note 27 and Frommel – *Taxation of branches and subsidiaries* at page 60. See also OECD commentary on Article 5 for the circumstances in which a subsidiary may be treated as a permanent establishment of the parent company.
49. Op. cit. supra, note 37.
50. *Cahiers de Droit Fiscal International.* Vol. 49 1964 at Page 77. "The delimitation between the country of residence and other countries of the power to tax corporations and/or their share holders." Also at page 97 it is stated "no general rules of international law define the territorial limitations of national powers of taxation with regard to corporations and share holders."
51. E.g. Knechtle, op. cit. supra, note 37, at page 37, he states "there is no prohibition of IDT in international customary law which would validate the principle 'ne bis in idem' in the fiscal sphere also."
52. E.g. see William Park in *Extra-territorial application of laws and responses thereto.* Edited by Professor C.J. Olmstead at page 147 he states: "Barcelona Traction does not of itself protect the parent in its capacity as shareholder, or the directors."
53. E.g. where foreign property or person are detained "illegally" by force. See also op. cit. supra, note 37.
54. A.R. Albrecht. "The taxation of aliens under International Law." *BYIL* 1952 at Page 156. See also Op. cit. supra, note 37b.

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ing. First, the foreign company shareholders in the subsidiary are, unlike a transient visitor, financial entrepreneurs who enter in the unitary state open-eyed, deliberately seeking commercial adventure. Second, not only is it in the nature of multinational operations that the unitary method is anticipated, but also the investment and the entry of the foreign parent company in the unitary state as promoter/shareholder/investor is in fact conditional on its subjugation to the unitary method. Finally, the financial investment in the subsidiary is substantial, in fact a majority shareholding.

In the circumstances the foreign companies have a sufficient presence, or are involved in a substantial economic activity, to justify jurisdiction by way of the unitary method directly against the foreign companies, insofar as the profits arising outside the territory are reasonably attributable to the contribution made to the earning of those profits.

However, where the profits of the foreign parent company are not properly attributable to the subsidiary, according to the reasonable connection school, jurisdiction would be improper where the taxation of the profits so attributed do not bear a reasonable relationship with the connection that the parent company has with the taxing state. This would occur where the rate of tax on the profits attributed to the subsidiary is such as to result in the substantial taxation of the profits that are not attributable to the subsidiary. Thus, if £ 60 were attributed to the local subsidiary, out of which £ 30 was improperly attributed, a rate of tax exceeding 50% would result in the taxation of the improperly attributed profits. For the improper taxation of those profits a substantial rate in excess of 50% would have to be chosen. The taxation would have to be substantial, for the parent company has arguably some connection through the subsidiary with the taxing state, and also so as to be reasonably quantifiable as being improper.

As a practical matter however, this kind of situation would probably be rare and easy to prove only in the most flagrant of circumstances.

Unitary taxation operates in a discriminatory and confiscatory manner

Finally, there are two more contentions that are implicit in the orchestra of protests by states against the use of the unitary method.

Discrimination

First, there is that central allegation that unitary taxation discriminates against foreign corporations operating through subsidiaries in the taxing state. Here, a distinction must be made between discrimination in the sense of inhibiting foreign investment in the country and discrimination against already established investment within the country. With regard to the former, General International Law does not prohibit a state from precluding or inhibiting investment and trade with it.[55] With regard to the latter, it must be stated that vis-à-vis the subsidiary company incorporated in the unitary state no question of discrimination against it qua foreigner arises as the subsidiary is not an alien but a national of the state even though there is investment by foreign companies in it.[56] The object of discrimination is properly the foreign conglomerate as a foreign entity operating within the state in the capacity of a shareholder.

This allegation is unfounded in the context of U.S. parent companies in the U.S. with foreign subsidiaries. Where there is a unitary relationship in this inverse situation the unitary method still applies. Further, the unitary method is applied regardless of the kind of national corporate investments in the subsidiary.

However, it has to be stated that there is arguably[57] in the impact of the application a discriminatory effect operating against foreign-based parent corporations. This is suggested in the Amicus Curiae[58] of the European Economic Community and the Governments of Australia, Japan and Switzerland in the Alcan Aluminum case for the following reasons.

First, it is asserted that the legal incidence falls on the domestic parent corporation in the case of a U.S.-based parent company, where as in the case of a foreign parent company with U.S. subsidiaries the foreign corporation is directly affected. The foreign corporation is directly affected since it is its income already taxed by foreign governments under separate accounting principles that is being taxed. There is little force in this argument in the context of the application of the unitary method since the foreign subsidiary of a U.S. parent company is similarly affected even if the legal incidence falls on the domestic corporation.

Second, it is asserted that there is a discriminatory effect in the context of the burden to comply with reporting requirements against foreign parent corporations as these are not as conversant with U.S.-accounting concepts as U.S.-based parent corporations. Here too the contention does not have force as a foreign subsidiary is in the circumstances likely to be as conversant as a foreign parent with U.S.-accountancy concepts. Further, in any event, the parent company as shareholder is obliged to see to it that the subsidiary is able to comply with the unitary state's regulations.[59]

Third, and related to the above, it is contended that a domestic parent has control over its subsidiaries whereas a domestic subsidiary does not have over its foreign parent. This is a fallacious argument as the condition of incorporating or investing in a unitary state by a foreign parent company is the acknowledgement with all its implications of the application of the unitary method. In fact put in the context of the ability of the foreign parent company to function via a sub-

55. Schwarzenberger. *A manual of International Law*, at page 87.
56. Op. cit. supra, note 54 at page 158.
57. Alcan Aluminum case op. cit. supra, note 1.
58. Ibid.
59. David Gill op. cit. supra, note 52 at page 169.

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sidiary in the unitary state – the compulsion to comply on the parent company with the unitary burdens is fairly apparent.[60]

Finally, it is asserted that vis-à-vis domestic parent corporations with foreign subsidiaries, U.S. legislation (i.e. the Internal Revenue Code provisions, including provisions on tax credits and deferrals) is equipped to alleviate double taxation. This is because the United States exercises tax jurisdiction on a residence or source of income basis. In the case of a foreign parent corporation with domestic subsidiaries, the foreign corporation is neither resident nor has a source of income so as to fall within the U.S. tax jurisdiction and the attendant double taxation relieving provisions. This would appear to constitute discrimination – but it has to be noted that it arises not so much from the impact of the application of the unitary method, but rather from the U.S. approach to exercising tax jurisdiction.

Another possible source of discrimination may be vis-à-vis purely domestic corporations operating locally. First, in a federal state the level of prices is not likely to differ substantially as between the respective national units. Therefore, usurpation of profits from low-priced states by high-priced states generated by the unitary method may not be a significant problem. Hence, a corporate conglomerate operating within a state subject to the unitary method is not attributed that measure of profit that is the consequence of the difference of the values of the components that are normally taken to indicate the measure of contribution made by an entity towards the earning of the total profits. This, however, is a flaw that results from the imperfections of the unitary formula as normally used in the U.S.A. If this were corrected there would be no difference. Second, in the case of a purely domestic company, not part of a conglomerate, the corporate personality has to be acknowledged. Only the profits earned by the company itself are taken into consideration. A company with a multi-jurisdictional character, on the other hand, is subjected to the unitary method with the result that additional extra-territorial income of foreign entities may be attributed to it.

Thus, unitary taxation may operate in a discriminatory manner against foreign entities. However, the position under General International Law as it stands[61] is that there is[62] no prohibition on discrimination as such of foreign entities in matters of taxation.

Confiscation

Second, it is contended that unitary taxation may result in bizarre situations where more than 100% of locally earned income may be taxed and local losses converted into notional taxable profits. The suggestion here is that in these circumstances the tax in fact operates as a confiscatory tax.

Confiscatory taxation may be illegal under International Law where it affects aliens.[63] Prima facie, particularly in the context of the parent company qua shareholder within the taxing state, in the circumstances described above the unitary method may have a confiscatory effect – specifically where it is indifferent to the subsidiary's ability to pay and lodges on that part of the subsidiary's income that is not properly attributable to its contribution towards the earning of those profits.

On the other hand, it must be emphasized, given that, according to the unitary method, the profits of the local entity are calculated without reference to the local entity itself and without reference to the profits arising within the state but essentially in the context of the contribution made by the subsidiary in the earning of the total profits of the unit, there is no confiscation (provided the unitary formula reasonably reflects contribution of the local enterprise). There is no confiscation as the geographical location of the actual profits has never been a factor in international fiscal law inhibiting state taxation. The subsidiary earned the profits even if the location of the profit is situated outside the taxing state's territory and in the ownership of a different personality. The tax must be conceived of as a proportion of the subsidiary's proportion of the total profits of the unitary business. As such it is not a confiscatory tax. If the conglomerate seeks to deprive the subsidiary of its share of the profits – this is a matter internal to the conglomerate and must not be allowed to contribute to a characterization of the taxation as confiscatory vis-à-vis the local enterprise. The tax may be confiscatory, however, where for instance 100% or more of the profit reasonably attributed under the unitary method is taxed.

CONCLUSION

To epitomize the General International Law position with regard to unitary taxation the following is asserted:

(1) No rule of General International Law exists which proscribes the use of the unitary method qua method.

(2) In the event of very excessive broadening of the tax base amounting to the substantial taxation of a foreign parent company an issue of excess jurisdic-

[continued on p. 88]

60. Ibid.

61. See for example (1) A.A. Knechtle, *Basic Problems in International Fiscal Law* Chapter 6. Page 53 where he states: "General public international law and national law does not a priori exclude fiscal discrimination against foreign nationals." (2) *Proceedings of the American Society of International Law*. 1911-14. Page 213. Mr. Howard Thayer states: ". . . very fact that treaties frequently contain clauses specifically providing against any such discrimination, seems a sufficient indication, that in itself, discriminatory taxation of aliens is not contrary to international law." (3) A.R. Albrecht. "The taxation of aliens under international law." *BYIL* 1952 Page 145 at page 170.

62. See proposal in UN Draft Code of Conduct on Transnational Corporations *ILM* 1984 603. Vol. 23. Paragraph 48 states: "Transnational corporations should receive (fair and) equitable (and non-discriminatory) treatment. . ."

63. See e.g. A.R. Albrecht. "The taxation of aliens under international law:" *BYIL* 1952 Page 145 at Page 171 and B.A. Wortly *Expropriation in Public International Law* 1952 at page 106. See also Brownlie op. cit. supra, 24 at page 533.

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Major Features of Corporate Profits Taxes in Selected Developing Countries

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I. OBJECTIVES AND SCOPE OF THE STUDY

This study describes the structure of corporate profits taxes in 32 developing countries selected from a diverse sample comprising countries in different geographical regions and at different income levels. The choice of this particular tax is made not on the basis of how large it is in terms of its share in the total tax revenues or gross domestic product (GDP) (in fact usually it is not),[1] but the strong presumption of supply-side economists that the taxpayers react strongly to the rates of taxes which fall on savings and investments. In particular, a major proposition advanced by the supply-side economists is that income tax systems result in distortions in the savings and investment behaviour, thereby adversely affecting the attainment of sustainable economic growth.[2]

The objective of the study is to examine for 32 developing countries the statutory provisions relating to the taxability of corporate profits and various special deductions and incentives, such as liberal depreciation allowances, differentially lower tax rates and tax holidays, that are allowed in these countries, which reduce the statutory or nominal rates of tax paid on corporate profits. The study computes average corporate tax rates by reference to the tax assessment statistics for 9 of the 32 countries included in this study for which the relevant data are available, namely Brazil, Cyprus, India, Kenya, Korea, Malaysia, Papua New Guinea, Syria and Thailand. This line of approach may be crude and even simplistic as compared to the elaborate methods formulated for the calculation of effective rates by several authors mainly for developed countries which require very substantial amounts of data.[3] Nonetheless, it does provide some quantitative indication of the impact of deductions and incentives which is a worthwhile exercise of conduct.

Although the focus of the argument of the supply-side economists is on high and progressive marginal rates of personal income tax, currently prevailing in the United States and also in a number of developing countries, their concern is inevitably applicable to the corporate profits tax as well, for at least two reasons. First, income taxes are applicable at progressively rising rates to the profits of corporate entities in a large number of the countries covered in this study. Second, insofar as the corporation is sometimes seen as an aggregate of shareholders and not an ultimate tax entity, the corporate profits tax can be considered a tax on shareholders,[4] together with the progressive personal income tax, can become an additional disincentive.

The scope of the study, which is by no means intended to be a comprehensive survey of all aspects of corporate profits taxes, is largely governed by the availability of relevant information. The basic source of information, which is listed in Appendix II of this paper, is the taxation guides and summary information prepared on the main features of these taxes by various consulting firms and research organizations. It is supplemented by the national sources of data, such as the annual Budget statements, annual reports of the relevant tax-enforcement agencies and related research studies prepared elsewhere on this subject. In the event of a conflict between two or more sources of information with respect to a specific provision, personal judgement is applied in deciding which interpretation seems most reasonable.

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Views expressed represent the opinions of the author and, unless otherwise indicated, should not be interpreted as official Fund views.

1. As Appendix I shows, the share is low except in the case of several mineral-producing countries which derive corporate tax revenue from extractive industries (e.g. Indonesia, Nigeria, Papua New Guinea, Trinidad and Tobago, Venezuela and Zaire), and those in which certain activities, such as large scale agriculture, tourism, and financial intermediation are undertaken by large corporate entities (e.g. Kenya, Malaysia and Singapore).
2. For an elaboration of their thesis, see Ved P. Gandhi, "Tax Structure for Supply-Side Economics in Developing Countries," DM/85/1.
3. See in particular Mervyn A. King and Don Fullerton (eds.), *The Taxation of Income from Capital* (Chicago: The University of Chicago Press, 1984); also, see George Kopits, "Factor Prices in Industrial Countries," DM/82/39; and Thomas Horst, *Income Taxation and Competitiveness in the U.S., Germany, France, U.K. and Japan* (Washington, D.C.: NPA Committee for Changing International Relations, 1977).
4. Depending on one's assumption regarding the incidence of corporate profits tax, the assumption in this context being that it is not shifted onto other factors of production or two consumers.

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The organization of this paper is as follows: Section II deals with the structure of corporate profits tax; Section III with taxation of dividends; and Section IV contains concluding observations.

II. CORPORATE PROFITS TAX

1. Introduction

The impact of the corporate profits tax depends on the effective tax rate, that is, nominal tax rate applied to profits, net of various deductible expenses and special incentives and shelters, such as special investment allowances, tax-exempt incomes, reduced rates of tax, etc.[5]

However, on account of the complexity of the statutory provisions relating to the corporate profits tax, it is extremely difficult and painstaking to estimate effective tax rates.[6] This section of the paper, therefore, focuses on analyzing in *qualitative terms* the broad features of the structure of corporate profits tax, including some of the major tax incentives and tax provisions which reduce effective tax rates for corporate profits. However, the concluding part will, as already indicated above, provide some illustrative data relating to the extent to which various deductions have tended to reduce the average tax rate in some of the countries covered here.

The analysis of corporate profits tax in this section covers the following matters: the definition of the tax base; the nominal rate structure; the coverage of deductible business expenses; the nature of the extent of tax exemptions; the differential tax rates; the carry-forward provisions; the treatment of capital gains; and the indexation provisions.

2. Nominal tax rate structure

The corporate entities in the developing countries under review are, with some minor exceptions, subject to a single levy usually called a corporate profit or income tax. The exceptions include supplementary taxes on corporate profits,[7] such as the "development tax" in Malaysia and Sudan, "excess profit taxes" in Malaysia and Nigeria, "defence tax" in Korea, the "national solidarity tax" in Morocco, "war surtax" and "municipal tax" in Syria, "super tax" in India, "surcharge" in Pakistan, and "housing tax" in Chile.

For the purpose of a cross-country comparison, the levels of nominal tax rates shown in Table 1 can be classified in three categories. First, at one extreme, high rates (55% or over) prevail in countries like Syria, Sudan, Israel, Pakistan, India, Ghana, Guyana and Peru.

Second, at the other extreme, fairly low rates (30-40%) prevail in countries like Egypt, Argentina, the Philippines, Papua New Guinea, Brazil, Colombia, Singapore, Thailand and Turkey. Finally, relatively moderate rates (40-50%) prevail in the remaining countries. The tax is payable on virtually all sources of corporate income at a uniform proportional rate in some countries and at graduated rates in others. Furthermore, differential rates of tax are applicable to certain types of corporate profits. Progressive rate schedules apply in eleven of the countries under review, but only in six of these countries, namely Egypt, Indonesia, Korea, Sudan, Syria and Venezuela, are the income bands and the gradient of the tax rates sufficiently wide for the rate structure to be analogous to the personal income tax rate schedules.[8]

3. Differentiation in tax rates

For a variety of reasons, the tax laws of the countries under review impose corporate profits tax rates on certain categories of income or certain groups of corporate entities that may be either higher or lower than the standard rates of tax prevailing in these countries.

The higher-than-standard rate applies in certain specific circumstances. The first one is that in countries where the maximum rate of personal income tax applicable to non-corporate profits is higher than the corporate tax rate, there is frequently a provision in their tax laws discouraging the formation of "closely-held" companies (shares being owned solely by family members) purely as a device for avoiding the higher rate of personal income tax. Second, it is aimed at the taxation of substantial rates of profits from natural resources, such as mining, as in Egypt, Indonesia, Nigeria, Papua New Guinea, Trinidad and Tobago, Malaysia and Venezuela; or banking in Pakistan. Third, some countries impose a higher than standard rate of tax on branches of foreign corporations (Argentina, Chile, India, Kenya, Pakistan and Papua New Guinea). The imposition of this differential tax often tends to be in lieu of withholding tax on dividends, to charge the head office on the basis of dividends distributed from profits earned by the branch and/or both. For instance, in countries such as Argentina, the higher tax rate on branch profits represents an arrangement in lieu of withholding tax on dividends, whereas in countries such as India, Pakistan and Papua New Guinea the higher branch profits tax rate reflects the fact that

5. In a number of the countries under review, some of the largest corporate entities operating in the modern sector of the economy (e.g. those exploiting mineral resources) are rarely subject to the "normal" corporate profits tax.

6. This difficulty is attenuated by some strides made in recent years by the establishment of some econometric techniques of measuring the impact of some of the most important incentives. See, for instance, N.J. Agell, "Subsidy to Capital Through Tax Incentives in the ASEAN Countries: An Application of the Cost of Capital Approach Under Inflationary Situations," International Monetary Fund, DM/82/73 (1982); and Liam P. Ebrill, "Taxes and the Cost of Capital: Some Estimates for Developing Countries," International Monetary Fund, DM/84/16 (1984). In addition, effective tax rates may vary from industry to industry, from one form of investment to another. See King and Fullerton, op. cit., for estimates of effective tax rates in the United States, the United Kingdom, Germany and Sweden.

7. The unemployment levy in Trinidad and Tobago is treated as a social security tax in this study.

8. Similar or identical personal income tax rates are also applicable to corporate entities in several other countries, such as Costa Rica, Dominican Republic, El Salvador, Guatemala and Honduras.

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TABLE 1
Nominal tax rates applicable to corporate profits in selected developing countries

Country	Regular tax rate	Special tax rate	Comments
Argentina	33	45	Special rate (SR) on branches of foreign corporations.
Brazil	35-40	6; 17	SRs on agriculture and public utility companies.
Chile	48.6	52.4	Includes housing tax; SR on branch income.
Colombia	40	36.8	SR on majority Colombian-owned companies.
Cyprus	42.5	25; 4.25	SRs on public and off-shore companies, respectively.
Egypt	10-32	40.55	SR on oil exploration and producing companies.
Ghana	55	35-45; 45; 50	SR on wholly Ghanaian-owned small companies; on agriculture and mining companies; and on industrial companies.
Guyana	55	45	20 percentage points of it is company income tax which is creditable to shareholder; SRs apply to nontrading and life insurance profits (for the latter the entire tax creditable to taxpayer).
India	46.1-56.4	56.4-61.5; 20.5; 71; 75	Tax rates inclusive of 2.5% surcharge; SRs on closely-held and foreign companies.
Indonesia	20-45	35	SR on mining companies in first 10 years of operation plus 60% excess profit tax.
Israel	61	...	Income tax of 35% on profits net of corporation tax (21% on total profits) is creditable to shareholders.
Ivory Coast	44	—	Regular rate (RR) includes 4% national contribution tax.
Jamaica	45	2.5; 35	Regular rate includes additional 10% company profit tax creditable to shareholders; SRs on international finance and agricultural companies.
Kenya	45	27.5; 40; 52.5	SR companies to mining, insurance, and foreign companies, respectively.
Korea	28.1-50.4	28.1-43.7	RR includes 27.5-32.5 of defence and resident tax (the latter at 7.5%); SR applies to "listed" companies, that is, those with shares quoted on local stock exchange.
Malaysia	50	5-40	RR inclusive of 5% development tax and 5% excess profit tax; SR applies to cooperative societies.
Mexico	5-42	2.5-21; 3-25.2	SRs on book-publishing and agriculture profits.
Morocco	44-52.8	—	RR includes 10% National Solidarity tax.
Nigeria	40-45	85	SR on petroleum companies; 2.5% minimum turnover tax on companies in construction sector.
Pakistan	57.75	42.75; 47.75; 52.75; 65	RR comprises 30% income tax, 25% supertax and 5% surcharge on income and supertax; SRs apply to foreign incomes, food processing companies, to public companies and to small companies, and to banking companies, respectively.
Papua New Guinea	36.5	35-48; 50	SRs apply to mining and to non-resident companies, respectively.
Peru	30-55	15-27.5; 10-18.3	SRs apply to gold mining and other mining companies, respectively.
Philippines	25-35	10; 35-45	SR applies, respectively, to insurance and closely-held companies.
Singapore	40	10	SR on certain finance companies.
Sudan	30-65	—	RR includes 5% development tax; maximum tax rate applicable to private companies at lower income level than to public companies.
Syria	14.5-92.4	—	RR includes a war surtax of 30% and municipal surcharge of 2 to 10% of the tax due.
Thailand	40	30; 50	SRs on "listed" companies and on company profits remitted abroad, respectively.
Trinidad and Tobago	50	20; 40-65	RR includes 5% unemployment levy; SR on life insurance companies and on petroleum cost (higher rate on marine operations).
Tunisia	46.5	40.1	SR on industrial companies; minimum tax payable at 1% of turnover by all companies.
Turkey	40	—	20% additional tax on undistributed profits.
Venezuela	18-50	67.7; 60	SR on oil and other mining companies, respectively.
Zaire	50	25-37.5; 20-60	SRs applicable, respectively, to "free zone" profits during first few years following the end of a tax holiday period, and to real estate companies, the latter being subject to a special schedular tax on their profits.

Source: Appendix II.

transfers to head offices are exempt from the withholding tax. In other words, they represent the practice of charging the head office on the basis of dividends distributed from branch profits. In contrast, the corporate tax on branch profits in Kenya tends to be higher than on domestic profits, even though the withholding tax is also applicable to branch profits remitted to the parent company as well as all other distribution of branch profits.[9]

9. In Chile, the corporate profits tax rate on branch profits tends to be higher because of the non-deductibility of an element of the tax (First Category Tax) from the computation of another (lower) element of the tax (additional tax).

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The lower-than-standard tax rate applies mainly to certain selective activities which may sometimes include one or more of the following:
(a) to certain sectoral activities such as agriculture (Brazil, Ghana, Jamaica, Mexico), manufacturing (Pakistan, Tunisia), mining (Ghana, Kenya), public utilities (Brazil) and non-trading (Guyana);
(b) to certain financial intermediaries (Cyprus, Guyana, Kenya, Jamaica, the Philippines, Singapore, Trinidad and Tobago);
(c) to majority-local ownership companies (Colombia, Ghana);
(d) to public, that is, with more diversified ownership as against closely-held, companies (Cyprus, Pakistan, Sudan, Thailand);
(e) to small companies (Ghana, Pakistan); and
(f) to cooperatives (Malaysia).

4. Liberal depreciation allowances[10]

The most significant of the business deductions concerns depreciation allowances. Depreciation allowances are deductible in all these countries. However, as shown in Table 2, the method of deduction applied and their extent varies considerably between the countries covered. Most countries permit deductions at a uniform rate during the life of the asset – the so-called straight-line method. However, the declining balance method, under which the annual rate of depreciation happens to be higher at the beginning of the life of the asset and lower at the end than that under the straight-line method, applies in eight countries, namely Ghana, Guyana, India, Jamaica, Kenya, Nigeria, Pakistan, and Trinidad and Tobago, and the optional method in four others, namely Egypt, Korea, Papua New Guinea and Turkey. Items covered usually include plant and machinery, industrial buildings (including housing for employees) and vehicles for which the annual allowance rates average at 15%, 5% and 20%, respectively. Some countries further explicitly permit enterprises using plant and machinery more extensively, that is, on a double or triple shift, to deduct additional depreciation. The computation depreciation in most of the countries is with reference to the book value or the historical price of the asset. However, some countries permit the deduction based on the replacement cost or at any rate the revaluation of the historical cost, this being the case in nine countries, namely Argentina, Brazil, Chile, Indonesia, Israel, Mexico, Peru, Tunisia and Turkey. Some countries permit depreciation deduction on an accelerated basis primarily in lieu of the inflation-adjustment value of the asset, although some of these countries further apply it as an instrument of attaining particular "pioneering"[11] objectives such as the promotion of investment, regional dispersion, export, industrialization, etc. Such accelerated depreciation is available in at least half of the countries covered here. The allowance usually extends to the cost of acquisition of plant, machinery and equipment in the first year and the rate of additional depreciation ranges from 5% (e.g. in Ghana) to as much as the full price of the asset (e.g. Cyprus, Korea, Malaysia).

In about two thirds of the countries covered here, the business entities receive investment allowances or investment tax credit in varying degrees. Such allowances or credits are either in lieu of, or in addition to, accelerated depreciation allowances or other incentives such as the differential tax rates or tax holidays. The rate of accelerated allowance ranges from as low as 5% (Ghana) to as high as 75-100% (the Philippines); that of the investment tax credit from 6-10% (Korea) to as much as 30% (Mexico); and that of investment grants to as much as 10-30% of expenditure on qualifying assets (Argentina). The underlying criterion for the availability of these allowances is that they are engaged in one or more of the "pioneering" activities, such as agriculture (Argentina, Korea, Jamaica, Nigeria, Turkey), upgrading of investment (Pakistan, Singapore), regional dispersion (Argentina, Kenya, Turkey), hotels (Cyprus, Kenya, Trinidad and Tobago), shipping and aircraft industry (India, Korea), mining (Korea), and production of certain capital goods (Venezuela).

The incentives on capital expenditure, in the form of an annual or accelerated depreciation and investment allowance (or tax credits or cash schedule in lieu thereof), also extend to expenditures on intangibles, such as research and development, manpower training, and outlays on export production. Such incentives include the following: (a) the deductibility of expenditure on manpower training (of twice the amount expended as in the case of Brazil and one and a half times as in Peru), and availability, in lieu thereof, of tax credits, as in Mexico, or cash grants as in Chile and Jamaica; (b) the deductibility of expenditure on research and development, as in Israel, Korea, Papua New Guinea, Singapore, and Trinidad and Tobago, and tax credits, in lieu of it, in Mexico; and (c) the deductibility of expenditure on export market development of up to 133% of expenditure, as in India and Trinidad and Tobago, and of special reserves for exports, as in Korea.

5. Tax holidays

Tax laws of a number of developing countries selected for this study extend "tax holidays" to certain enterprises. The holidays are in the form of exemption from tax on all or part of the profits and the duration of exemption varies. In addition, most countries allow such enterprises to carry forward losses for offset against future years' profits. Enterprises eligible for tax holidays are usually engaged in certain "pioneering" activities. As Table 2 shows, three fourths of the countries covered here extend such holidays, most of them[12] on the entire amount of profits. The duration of exemption in these countries is usually for a fixed

10. In relation to the rates of inflation as well as the ordinary wear and tear of assets concerned.
11. Hereinafter the expression is used in its broadest sense.
12. India extends it to a certain proportion of profits of the "tax holiday" companies, while Cyprus extends it (for an indefinite period) to certain percentages of the export earnings from locally-manufactured or produced goods and rendering of professional services abroad.

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TABLE 2
Schedule of incentives available to corporate entities subject to profits tax in selected developing countries

Country	Formula	Asset price	Depreciation: Initial P&M; B; V	Depreciation: Annual P&M; B; V	Availability of investment allowance tax credit or development resale P&M	Maximum shifts and increases in normal depreciation	Basis of inventory valuation[1]	Carry-over of losses	Period of tax holiday
			(In percent)					(Number of years)	
Argentina	St. line	Curr.	...; ...; ...	5-10; 2; 20	10-35 (ITC)	...	Cost/Market[1]	10	10
Brazil	St. line	Curr.	10; 4; 20	10; 4; 20	—	DS-TS (50-100)	Cost/Market[1]	4	15
Chile	St. line	Curr.	6.6; 3.3-5.3; 18.6	5; 2.5-4; 14	—	Unspecified	Replacement Cost	5	None
Colombia	St. line	Hist.	...; 40; ...	10; 5; 20	—	3 (25-50)	LIFO	5	None
Cyprus	St. line	Hist.	100; 100; ...	10; 3-4; 20	15-45 (IA)	—.	Cost/Net Sale Price[1]	Unltd.	Varies
Egypt	Opt.	Hist.	30-40; 2-5; 20-25	10-15; 2-5; 20-25	—	—	Opt. LIFO/FIFO	5	5
Ghana	Dec. bal.	Hist.	10-25; 3; 5-15	5-20; 3; 5-15	5 (IA)	...	...	Nil	5-10
Guyana	Dec. bal.	Hist.	7-33.3; 3-5; ...	7-33.3; 3-5; ...	...	—	Cost/Market[1]	Unltd.	...
India	Dec. bal.	Hist.	60-100; 25-40; ...	10; 2.5-15; ...	—	DS-TS (50-100)	Cost/Market[1]	8	8[2]
Indonesia	St. line	Curr.	...; ...; ...	...; ...; ...	20 (IA)[3]	...	Av. Cost/LIFO	Unltd.	2-6
Israel	St. line	Curr.[4]	10-15; 2-8; 15-20	10-15; 2-8; 15-20	—	—	FIFO/Av. Cost	Unltd.	5[5]
Ivory Coast	St. line	Hist.	5; 20; 30.3	5; 10; 33.3	—	—	Cost/Market[1]	3	5
Jamaica	Dec. bal.	Hist.	20; 20; 12.5	...; 5; 12.5	20-40 (IA)[6]	Unspecified	Cost/Market	Nil	10
Kenya	Dec. bal.	Hist.	12.5; 2.5-4; 25	12.5; 2.5-4; 25	20 (IA)	...	Av. Cost/FIFO	Unltd.	None
Korea	Opt.	Hist.	100; 1.7-4; 20	6.6-20; 2; ...	6-10 (ITC)	DS-TS (20)	LIFO/FIFO	3	5
Malaysia	St. line	Hist.[7]	100; 12; ...	6-20; 2; ...	25 (ITC)[8]	Unspecified	Cost/Market[1]	Unltd.	2-8
Mexico	St. line	Curr.[4]	35; 30; 45	10; 5; 10	30 (ITC)	—	Market/LIFO	4	None
Morocco	St. line	Curr.[4]	...; ...; ...	...; ...; ...	12 (IA)	—	FIFO/Av. Cost	5	10
Nigeria	Dec. bal.	Hist.	32.5; 15; 32.5	12-5; 10; 12-5	25 (IA)	—	FIFO	4	3-5
Pakistan	Dec. bal.	Hist.	40; 15; 25	10; 5; 10	15 (ITC)	DS-TS (50-100)	Cost/Market[1]	6	5
Papua New Guinea	Opt.	Hist.	40; 23; ...	20; 3; ...	—	Unspecified	Av. Cost/FIFO[1]	7	2
Peru	St. line	Curr.[4]	5-10; 3; 5-15	5-10; 3; 5-15	Varies (ITC)[9]	—	Av. Cost/FIFO[1]	4	None
Philippines	Opt.	Hist.	...; ...; ...	...; ...; ...	75-100 (IA)	—	Cost/Market[1]	6	None
Singapore	St. line	Hist.	20; 25; ...	5-16; 3; ...	33.3-50 (IA)	—	Av. Cost/FIFO[1]	Unltd.	5-10
Sudan	St. line	Hist.	5-15; 2.5-10; 20-25	5-15; 2.5-10; 20-25	—	—	FIFO	5	5
Syria	St. line	Hist.	...; 5-20; ...	...; 5-20; ...	—	—	...	5	None
Thailand	St. line	Hist.	Unspecified	20; 5; 20	20 (IA)	—	Cost/Market[1]	5	3-8[10]
Trinidad and Tobago	Dec. bal.	Hist.	30-45; 12; 25	10-25; 2; 25	20 (IA)[3]	—	Cost/Market[1]	Unltd.	10
Tunisia	St. line	Curr.[4]	...; ...; ...	...; ...; ...	—	—	...	3	3-5
Turkey	Opt.	Curr.[4]	...; ...; ...	...; ...; ...	30-60 (IA)	—	Av. Cost	5	None
Venezuela	St. line	Hist.	6-20; 2-4; ...	6-20; 2-4; ...	14-20 (ITL)	—.	FIFO/Av. Cost	5	10
Zaire	St. line	Hist.	10-15; 2.5-5; 25	10-15; 2.5-5; 25	—	—	FIFO	2	5

Source: Appendix II.

Notes:
1. Whichever is lower, but not LIFO.
2. Only on 25% of profits.
3. As an alternative to tax holiday.
4. After revaluation of the balance sheet.
5. Exempt only from income tax at 35% (not from corporation tax of 40%).
6. To agriculture and sugar industry.
7. For some assets on a current basis.
8. As an alternative to accelerated depreciation.
9. On reinvested profits.
10. For additional 5 years, exemption of 50%.

Key:
... means relevant information not available;
— means the countries concerned do not extend the incentive;
St. line = Straight line;
Dec. bal. = Declining balance;
Opt. = Optional;
Unltd. = Unlimited;
IA = Investment allowance, usually on plant and machinery;
ITC = Income tax credit;
DR = Development rebate;
DS-TS = Double or triple shift;
P&M = Plant and machinery;
B = Industrial buildings;
V = Vehicles;
Av. Cost. = Average cost;
FIFO = First-in first-out; and
LIFO = Last-in first-out.

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period, but is renewable at the discretion of the authority, this being the case in countries like Cyprus and Pakistan. The coverage of pioneering activities of such enterprises includes one or more of the following operations:

(a) General economic development (Egypt, Jamaica, Singapore, Sudan);
(b) Certain sectoral developments, such as priority areas (Indonesia, Ivory Coast, Morocco), agriculture (Ghana, Jamaica, Mexico, Pakistan, Venezuela), manufacturing (India, Jamaica, Peru, Trinidad and Tobago), mineral development (Ghana, Mexico, Peru), construction (Mexico), shipping (Cyprus, Jamaica), or tourism (Kenya, Malaysia, Peru, Trinidad and Tobago);
(c) Promotion of indigenous ownership (Papua New Guinea);
(d) Promotion of investment (Kenya, Korea, Thailand, Tunisia), reinvestment of profits (Syria), and modernization of plant and machinery in certain activities (engineering and technology in Korea and Singapore);
(e) Promotion of financial intermediaries (Cyprus, Mexico, Trinidad and Tobago) and "off-shore" transactions (Cyprus, Singapore);[13]
(f) Promotion of labour utilization or generation of additional employment (Malaysia, Mexico, Singapore, Tunisia);
(g) Promotion of exports (Argentina, Cyprus, Nigeria, Papua New Guinea, Singapore, Sudan, Turkey); and
(h) Regional dispersion of development (Argentina, Brazil, India, Indonesia, Pakistan, Peru, Turkey, Zaire).

Because pioneering enterprises tend to incur losses in the early years of their operation, most countries permit a carry-forward of such deductibility or tax exemptions either indefinitely or subject to a maximum period. The provisions relating to the unused portions of losses, tax deductible expenditures, and tax exempt incomes and losses incorporated in the tax laws of these countries are very complex. However, the gist of these provisions is that all countries except Ghana and Jamaica permit a carry-forward of losses. Eight of the countries[14] permit it without any time limit, while the remaining twenty-two countries restrict it to a period ranging from 2 to 10 years, the most common duration being 5 years. There are similar provisions in respect to the carry-forward of unused depreciation (including accelerated and investment) allowance and tax exemptions, but the position in each country is much too complex to permit even very broad generalizations concerning their extent or duration. In the absence of their indexation, the economic significance of these carry-forward provisions to the enterprises concerned tends to be limited in an inflationary context.[15]

6. Tax treatment of capital gains

The tax treatment of capital gains realized by corporate entities in the countries under review represents a diversity of situations. At one extreme, some countries such as Indonesia, Peru, Thailand, Turkey, Venezuela and Zaire treat all of their capital gains as regular income taxable at normal rates on business profits, while at the other extreme, countries such as Chile,[16] Papua New Guinea and Singapore exempt them altogether. An intermediate category of countries, such as Kenya, Jamaica and Morocco, tax only between one fourth to one half of the amount of gains made while some others, such as Argentina, Cyprus and Nigeria, apply a reduced rate of tax on all of the capital gains; then, countries like Ghana, Malaysia and Sudan apply the tax only on long-term gains, and yet others like Pakistan and the Philippines which apply reduced rates of tax, respectively, on real estate and shares not traded on the local stock exchange. A number of countries exempt from tax the following categories of capital gains:

(a) Reinvested capital gains from: (i) all sources provided that the reinvestment is made within a specified period after realization of such gains, this being the case in Brazil, Colombia, Egypt, Ivory Coast, Korea and Mexico where these gains would be otherwise taxable at the standard rate of tax and also in Pakistan and the Philippines where they would be taxable at special reduced rates of tax; (ii) capital gains from long-term holdings which would otherwise be subject to regular tax (India); and (iii) capital gains from real estate which would otherwise be taxable at a reduced rate of tax (Mexico).
(b) Gain from: (i) shares (Argentina,[17] Cyprus, Korea); (ii) all assets, other than land held for under 6 years (Malaysia); (iii) all long-term gain (Trinidad and Tobago); and (iv) shares traded on the local stock exchange (Jamaica).

The extent to which all of these provisions result in the reduction of the nominal tax rate payable by corporate entities is difficult to quantify except in the following cases where a special tax rate applies to all categories of taxable capital gains: Papua New Guinea and Singapore (0); Argentina (15%);[18] Cyprus (20%); Ghana (55-15%, scaled to the duration of holding of assets ranging from 5 to 20 years); Malaysia (5% on assets held over 5 years and 40% on others); Nigeria (20%); the Philippines (10-20% depending on the size of profits and whether the gains relate to the shares traded on the local stock exchange); and Sudan (40%).

13. These kinds of activities can form an important "ingredient" of economic development and growth of these economies.
14. Namely, Cyprus, Guyana, Indonesia, Israel, Kenya, Malaysia, Singapore and Trinidad and Tobago.
15. However, see subsection 7 below.
16. This is not to deny that capital gains do fall into the tax net indirectly through the tax treatment of revaluation surpluses. For an elaboration of this point, see Milka Casanegra de Jantscher, "Taxing Business Profits During Inflation: The Latin American Experience," *International Tax Journal* (Winter 1976). Also see her paper, "Chile's Experience with Indexation of the Tax System," prepared for presentation at the XXXVIII Annual Conference of the International Fiscal Association in Buenos Aires, 16-21 September 1984.
17. This favourable treatment is, however, somewhat mitigated by the existence of annual tax on the corporate entity's capital value.
18. Ibid.

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7. Indexation provisions

The tax provisions in respect of inflation adjustment of profits of corporate entities vary consistently between countries. While a country like Israel provides for a comprehensive scheme of adjustment of most, if not all, elements of corporate entities' taxable profits, some other countries allow inflation adjustment of specific items, such as the base for depreciable assets, inventories, and certain items of the balance sheet, and yet others do not make any provisions for inflation adjustment of any of the items which enter into the computation of taxable profits. As indicated in subsection 4 above, a number of countries allow replacement or revaluation of the book value of assets as a basis of depreciation.

With respect to inventories, about two thirds of the countries concerned here apply the cost price or market value, whichever is lower, as a basis of valuation. However, the remaining one third of the countries permit last-in first-out (LIFO) or a variation of it as a basis of valuation, this being the case particularly with countries like Chile, Colombia, Egypt, Indonesia, Korea and Mexico. Turkey, too, allows a revaluation of inventories whenever their market price is at least 10% higher than the cost price.

The inflation adjustment or "monetary correction" of certain balance sheet items is permissible in countries like Argentina, Brazil, Chile, Indonesia, Mexico, Morocco, Tunisia and Turkey. For instance, Argentina allows the reduction of net capital which is exposed to inflation, defined as the excess of monetary assets and inventories (that is, all assets other than fixed assets, investment in shares, investment abroad, and bad debt provisions, net of all monetary liabilities), with reference to the wholesale price index. The excess of assets over liabilities is deductible from the assessable income and vice versa. Brazil allows "monetary correction" for fixed assets, permanent investment, deferred shares, and shareholders' equity; the correction amount for assets is credited and that for equity debited to a separate account and the net debit balance, if any, is tax deductible. In the case of Turkey, all assets other than land and buildings can be revalued if the credit of the asset exceeds 5,000 LT. In Chile, "monetary correction" charges arising from loans used for corporate entity's operations are tax deductible. In Mexico, corporate entities with a reasonable leverage in their financial structure are allowed an additional deduction in recognition of inflation. Several other countries' tax laws contain fairly general provisions for the revaluation of various balance sheet items (e.g. Morocco, Peru, Tunisia and Turkey).

However, by far the most comprehensive scheme of indexation of business taxation exists in Israel since the enactment of a new legislation in August 1982. It provides for an inflation adjustment of the tax base so as to make taxation neutral with respect to inflation. Its essential feature is the system of "capital maintenance" which consists of the following elements: (a) the capital maintenance allowance defined as the excess of paid-up capital, unallocated profits, and loan capital over the "protected assets" (comprising unquoted securities, real estate, vehicles, aircraft, ships and goodwill), multiplied by the rise of the consumer price index; (b) the additional charge arising from the erosion of capital; (c) the adjustment of depreciation; (d) a flat-rate reduction from the amount of taxable income arising from the erosion of income during the fiscal year; (e) the adjustment of the amounts of losses carried forward; and (f) the adjustment of capital gains taxation. Wherever the protected assets exceed the aggregate capital employed (i.e. the sum of paid-up capital, unallocated profits and loan capital), there is, of course, no erosion of capital and the negative adjustment (in (b) above) has to be offset against (i) previous years' losses carried forward, adjusted for inflation; (ii) finance expense; (iii) the amount of depreciation adjustment for inflation, (iv) the inflationary element in capital gains, (v) current year's losses; and (vi) against tax-free income.

These principles and bases of revaluation of assets in the above-mentioned countries are applicable in the computation of capital gains as well as to that of the regular corporate profits.

8. Average corporate tax rates in some countries

The income tax systems of the countries reviewed contain a number of incentives and tax shelters which undoubtedly reduce the amount of profits liable to the corporate profits tax. The tax assessment statistics for nine of these countries provide some quantitative indication of the impact of these provisions, as shown in Table 3. It must, however, be treated with much cau-

TABLE 3
Percentage of corporate taxes assessed to total corporate income assessed in some countries

(*In percent*)

	Year	Assessed tax rate[1]	Nominal tax rates
Developing countries			
Brazil	1981	17.6	35-40
Cyprus	1980	14.6	42.5
India	1978/79	49.8	46.1-56.4
Kenya	1977	40.9	45
Korea	1978	34.7	28.1-50.4
Malaysia	1976	39.6	50
Papua New Guinea	1977	28.0	36.5
Syria	1976	27.1	14.5-92.4
Thailand	1978	32.4	40
Developed countries			
Canada	1980	35.6	50
United Kingdom	1979	35.9	40; 52[2]
United States	1980	35.4[3]	17-46

Sources: Appendix II; and Annual Reports of tax-enforcing agencies.

Notes:
1. The ratio of corporation tax assessed to total assessed income of the corporations.
2. The lower rate applies to small companies.
3. Relates to returns of active corporations.

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tion for a variety of reasons. First, tax assessment data contain only reported profits and often exclude profits which are entitled to tax holidays because separate data for such profits are usually not available. Second, the definition of profits, that are subject to tax, varies in each country because in some countries it refers to total reported income while in others it refers to adjusted gross income and yet in others simply net taxable income. Third, separate data are not generally available for each category of deductions and incentives identified in the preceding sections. Finally, the aggregate nature of the available statistics further hampers the separation of corporate entities that are subject to a standard rate of tax from those which are subject to differentially higher or lower rates of tax.

The extent of reduction is particularly high in countries such as Brazil, Cyprus and Syria; fairly moderate in Korea, Malaysia, Papua New Guinea and Thailand; and, as in the case of the developed countries reviewed here (Canada, the United Kingdom and the United States), relatively small in countries like India and Kenya.

III. TAXATION OF DIVIDENDS

1. Introduction

This section of the paper examines the tax treatment of distributed profits at the corporate entity's and shareholder's level both separately and together. This is a matter of considerable importance in several respects as it can affect the availability of equity capital. First, at the corporate entity's level, the differential treatment of interest and dividend payments can affect its choice of method of raising finance. For instance, to the extent that dividends are not deductible in the computation of taxable profits whereas interest payments, which are not in the nature of disguised dividends, are, the business entity would be more inclined to raise finance through borrowing rather than issue of shares. Second, at the shareholder's level, it would affect his post-tax rate of return, unless the dividends were either tax exempt or subject to tax credit for (or some such imputation of) the corporate profits tax already paid by the entity and thereby influence his choice of portfolio. Third, at the corporate entity's and shareholder's level taken together, the combined impact of the personal income tax and corporate profits tax can be of major significance for the structure of corporate finance because in the absence of imputation of tax already paid on the distributed business profits to shareholders, such profits become subjected to taxation at both the corporate entity's and shareholder's level while the undistributed profits are subjected only to corporate profits tax. Insofar as one regards the business entity as an aggregate of shareholders, rather than a distinct entity, there is then a "double" taxation of shareholders on dividend income. Fourth, the tax treatment of capital gains at both the corporate entity's and shareholder's level can also affect the decisions of the corporate entity's management, which in essence reflects its shareholder's decision, concerning the distribution of profits. Finally, in an inflationary context, the tax treatment of inflation-related profits and capital gains also becomes an important consideration. This section of the paper, therefore, examines the tax treatment of corporate profits at both the corporate entity's and shareholder's level in subsection 2, the relevance of capital gains and indexation provisions in subsection 3, and finally pulls together the different strands of analysis in subsection 4.

2. Taxation of business profits and dividends

Unless business profits are subject to a differential rate of tax for specific reasons examined in Section III(6) above (e.g. pioneering activity, indigenous ownership, regional dispersion), a single tax rate applies in all countries with the exception of three countries, namely, Guyana, Israel and Jamaica. These countries apply differential tax rates on distributed and undistributed profits by means of an intricate arrangement essentially consisting of two taxes, namely, a corporate profits tax and a company income tax[19], of which the latter is given as a credit against the taxpayer's income tax assessment. Such a method of taxation leads to higher differential tax rates on retained profits of 55% in Guyana, 61% in Israel and 35% in Jamaica, as against on distributed profits of 35% in Guyana, 40% in Israel and 35% in Jamaica.

In the absence of any other tax provision in regard to corporate profits distributed to shareholders, it can be said that, at the corporate entity's level, none of the countries' income tax systems provide any tax relief to corporate profits, from the double taxation of distributed profits or dividend income. At the shareholder's level, relief from such double taxation is available in varying degrees and in different forms. First, these countries provide a full relief in the sense that either dividends are not taxable in the hands of shareholders, or that they receive credit for all of the taxes paid by the corporate entity on distributed profits, this being the case, for instance, in Mexico, Singapore, Sudan and Turkey. Second, all dividends are taxed by means of a final withholding tax at a rate which is considerably below the prevailing maximum marginal rate of personal income tax, as in the case, for example, of Argentina, Brazil, Korea (in part), the Philippines and Zaire. Some specified dividends are also taxed on that basis in Tunisia and Venezuela.[20] Third, several countries allow tax credits equivalent to varying proportions of tax already paid in distributed profits, this being the case, for instance, in Chile, Colombia, Korea, Malaysia, Thailand, and Trinidad and Tobago. Fourth, some countries permit the exclusion of up to a specified proportion of dividends from taxable income as in the case of Ivory Coast or up to a maximum amount of specified or all dividends as in the case of

19. In Jamaica it is called an additional company profit tax.
20. Reinvested dividends in Tunisia or mining companies' dividends in Venezuela.

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India, Pakistan or Thailand. Consequently, for all practical purposes, it follows that even though a number of countries either do not permit any imputation to the shareholder of the tax actually paid on the distributed profits or the extent to which they permit it is most probably very insignificant, they nonetheless extend various alternative forms of important reliefs affecting the shareholder's tax liability.

3. Capital gains arising from retained profits

The shareholder and the corporate entity can conceivably avoid such double taxation of distributed corporate profits by means of the maximization of retained profits particularly when their tax systems tend to extend favourable treatment to capital gains on shares (e.g. Cyprus, Egypt, Ivory Coast, Jamaica, Kenya, Nigeria, the Philippines, Mexico, Morocco and Papua New Guinea), and at the same time do not impose additional taxes on retained profits. Insofar as such additional rates are imposed on "closely-held" companies, the scope for reducing the double taxation of distributed corporate profits may be lessened for such companies, but it would still be possible for publicly-held companies.

4. Combined tax treatment of distributed profits and capital gains

When the tax treatment of distributed profits and capital gains is examined together, it appears that the "double" taxation of distributed corporate profits is not as serious a problem in developing countries. This is due to the fact that the income tax systems of a number of the countries covered here allow a complete or partial imputation to the shareholder of taxes paid by the corporate entity on the distributed profits, shareholders receiving dividends from "pioneer" companies during their tax holiday period are, in most of the countries, exempt from personal income tax on such dividends. Furthermore, shareholders are, in a number of countries, either completely exempt from taxation on realized gain from shares or are subject to preferential treatment such as lower than the standard rates of personal income tax or exclusion of a certain proportion of capital gains from the sale of shares. Consequently, the extent of "double" taxation is considerably reduced.

IV. CONCLUDING OBSERVATIONS

The analyses of the provisions of corporate profits tax in the preceding sections lead one to make two broad generalizations about the structure of this tax in developing countries. First and foremost, various investment incentives are generous enough to considerably reduce the cost of capital and lower the average tax burden as compared to what is incorporated in the nominal tax rate schedules. Second, the so-called "double" taxation of distributed corporate profits both at the business entity and shareholder level, is considerably neutralized by a complete or partial imputation to shareholders of taxes already paid at the corporate level and by the favourable tax treatment of capital gains made by both the corporate entity and the shareholder. Consequently, dividend incomes are not necessarily always taxed more heavily than interest incomes.

APPENDIX I

Significance of corporate profit tax in revenues of developed and developing countries[1]

(In percent)

	Ratio of corporate profit tax revenue to GDP[2]	Ratio of corporate profit tax to total revenue
Selected developing countries		
Chile	2.15	6.30
Colombia	1.66	13.32
Cyprus	1.01	4.59
Egypt	3.37	9.00
Ghana	...	11.99
India	1.34	10.21
Indonesia[3]	16.40	67.24
Israel	3.91	9.54
Ivory Coast	1.35	5.80
Jamaica	1.89	8.19
Kenya	4.67	25.18
Korea	2.13	10.86
Malaysia	8.34	29.90
Mexico	3.11	20.42
Morocco	2.33	8.78
Nigeria	12.33	59.71
Pakistan	1.46	9.06
Papua New Guinea	7.44	32.79
Peru	2.25	12.72
Philippines	1.28	11.31
Singapore[3,4]	7.50	24.79
Sudan	...	9.99
Thailand	1.55	11.41
Trinidad and Tobago	23.15	54.52
Tunisia[3]	2.47	7.42
Turkey	1.95	8.64
Venezuela	16.03	57.13
Zaire	4.15	20.18
Average	5.20	20.03
Selected developed countries		
Canada	3.44	11.22
France	2.25	5.45
Germany	1.01	3.46
Japan[5]	3.34	26.02
United Kingdom	3.38	9.49
United States	1.65	7.48
Average	2.51	10.52

Sources: Government Finance Statistics Yearbook (1983); *International Financial Statistics Yearbook* (1983); and *International Financial Statistics* (July 1984).

1. The data are for 1980 or the nearest fiscal year available in each case.
2. GDP = gross domestic product (calculated on fiscal year basis).
3. Based on estimated corporate profits tax data.
4. Based on estimated GDP data.
5. Based on estimated total revenue data.

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APPENDIX II

Sources of information and data

The secondary sources of information used in the preparation of the study are as follows:

1. Information Guides on *Doing Business* in most of the countries covered here by Price Waterhouse & Co. (U.S.A.: latest edition).
2. *Tax and Trade Guide* on some of the countries, Arthur Andersen and Co. (U.S.A.: latest edition).
3. *Business Study* on some of the countries covered here, Touche Ross International (U.S.A.: latest edition).
4. *Taxation* in some of the countries covered here, Deloitte Haskins and Sells (New York: latest edition).
5. *International Tax Summaries: 1983,* Coopers and Lybrand (U.S.A.: 1983).
6. *Corporate Taxes: A Worldwide Summary,* Price Waterhouse & Co. (New York: 1983).
7. *International Tax,* Business Services, Deloitte, Haskins and Sells (New York: loose-leaf series).
8. (a) African Tax Systems;
   (b) Taxes and Investment in the Middle East;
   (c) Taxes and Investment in Asia and the Pacific;
   (d) European Taxation; and
   (e) Taxation of Companies in Europe, by International Bureau of Fiscal Documentation (Amsterdam: loose-leaf service).
9. Summaries of Tax Structure prepared by the Fiscal Affairs Department of the International Monetary Fund (unpublished).
10. *For Israel:*
    a. *World Tax Report* (July 1982), p. 13.
    b. *Tax-Free Trade Areas of the World,* Walter H. and Dorothy B. Diamond, Vol. 2 (New York: Matthew Bender, 1981), pp. 4-5.
    c. The *World Yearbook,* 1982 (Tel Aviv: 1982).
    d. *Summary Information on Business Organization, Accounting, Taxation and Investment: Israel,* Kesselman and Kesselman (Tel Aviv: 1979) pp. 62-87.
    e. J.F. Pick, "Introduction of an Inflation-adjusted Tax Base in Israel," *Bulletin of International Fiscal Documentation* (1983), pp. 259-263.
11. *Technical Assistance Reports* on relevant countries (unpublished), prepared by IMF staff members and consultants following visits to these countries (Washington, D.C.: International Monetary Fund, current issues).

BILATERAL AGREEMENT BETWEEN DENMARK AND SWEDEN SUPPLEMENTING THE MULTILATERAL NORDIC INCOME TAX CONVENTION

INTRODUCTION

In Bulletin 1986, No. 3, at 104, we published an unofficial translation of the Multilateral Nordic Income Tax Convention.

On 15 April 1986, Denmark and Sweden signed a bilateral Agreement, effective from 1 January 1987, regarding so-called frontier workers. This Agreement replaces the former provisions of a treaty of 16 November 1973 which were maintained temporarily by para. XII of the Protocol to the Multilateral Convention.

An unofficial translation of the bilateral agreement is reproduced below.

AGREEMENT BETWEEN THE GOVERNMENT OF THE KINGDOM OF DENMARK AND THE GOVERNMENT OF THE KINGDOM OF SWEDEN CONCERNING THE TAXATION OF SO-CALLED FRONTIER WORKERS

The Government of Denmark and the Government of Sweden,

Desiring to conclude an Agreement concerning the taxation of so-called frontier workers, have agreed upon the following provisions:

Article 1

1. Notwithstanding the provisions of paragraphs 1 and 2 of Article 15 of the Convention of 22 March 1983 between Denmark, Finland, Iceland, Norway and Sweden for the avoidance of double taxation with respect to taxes on income and on capital, income derived by a resident of Sweden in respect of continuous personal services performed in Denmark shall be taxable only in Sweden, provided that such person is regularly present at his permanent address in Sweden.

2. Notwithstanding the provisions of paragraphs 1 and 2 of Article 15 of the Convention of 22 March 1983 between Denmark, Finland, Iceland, Norway and Sweden for the avoidance of double taxation with respect to taxes on income and on capital, income derived by a resident of Denmark in respect of continuous personal services performed in Sweden shall be taxable only in Denmark, provided that such person is regularly present at his permanent address in Denmark.

3. The provisions of paragraphs 1 and 2 shall apply only if the services last for a continuous period of at least 6 months.

4. The expression "continuous personal services" refers to an employment situation which is entered into with the intention of its being the taxpayer's main occupation.

5. 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.

6. The provisions of the Convention, other than paragraphs 1 and 2 of Article 15, shall not be affected by this Agreement.

Article 2

This Agreement shall enter into force on the day on which the two States have notified each other that all steps necessary for the entry into force in that particular State have been taken, and shall thereupon have effect with respect to income derived on or after 1 January 1987.

In witness whereof the undersigned, duly authorized thereto, have signed this Agreement.

Done at Stockholm, this 15th day of April 1986, in duplicate, in the Danish and Swedish languages, the two texts being equally authentic.

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THE MALTA/LIBYA DOUBLE TAXATION CONVENTION

Treaty Shopping in Unexpected Quarters?

By Edwin A. Vella

INTRODUCTION

The double tax treaty between Malta and Libya is unique in many respects, not least because it seems to be the only document of its kind signed by Libya, and it also seems to work fairly well in practice.

The Convention Between the Government of Malta and the Government of the Libyan Arab Republic for the Avoidance of Double Taxation with Respect to Taxes on Income was signed in Tripoli on 5 October 1972 (or the 27th of Shalom 1392 Hijrija), and it came into effect as from 1 January 1973. Notice of termination could (but has not) been given after the year 1975, and although both Malta and Libya, since the date of signing, have had profound internal constitutional and other changes, the agreement is still recognized as valid by the two sides and given effect in practice.

It may not always be very clear to an accountant or lawyer as to what is happening from the Libyan end in matters of taxation, but as this article is written mostly from the Maltese point of view and consequential situations, this may not be very important.

SUMMARY OF THE CONVENTION

The uniqueness of the Convention commences with the list of taxes to which the Convention applies. From the Maltese end, the tax is described simply "the income tax". From the Libyan side, however, there are such unusual items as taxes on professional profits which arise from professional activities, and also, as a separate item, taxes on profits realized by practising Free Professions. It is not at all clear whether the two taxes hit different sources of income or whether they are repetitions. Listed among the Libyan taxes there is also the "Al-Jihad tax", which is translated neutrally as meaning "Defence Tax". Unofficial translations include the "Holy War tax". This tax is levied as a surcharge at a fairly low rate on top of the other taxes.

The Convention is clearly based on those in use at the time that the OECD Models were being formulated. There are, however, many surprising twists to the normal pattern, especially Article 3 which is headed "The Tax Home", and which states that "Without prejudice to the provisions of the Convention, the Tax Home of any income shall be deemed to be the contracting state in which the income arises". This seems to imply a fairly emphatic swing from the normal principle that the country of residence of the taxpayer should have the prior right of taxation, in the diametrically opposite direction whereby preference is given to the country of origin. This principle is in fact reproduced in many of the individual Articles as will be seen below.

The Article on *permanent establishment* is practically pure OECD, as are also the Articles on *business profits, shipping* and *air transport,* and *associated enterprises.*

The Article on *immovable property* is the first one where the "tax home" principle comes into play, as it is stated that this income is only taxable in the Contracting State in which the property is situated. The home territory of the taxpayer is given no right to levy tax whatsoever.

The same principle applies to *dividends* and *interest.* These are only taxable in the country of origin and not at all in the country of residence of the taxpayer. In the case of interest, however, it is set out that ". . . if the recipient of the interest, being a resident of a contracting state, has in the other contracting state in which interest arises a permanent establishment with which the debt claim from which the interest arises is effectively connected. . . the provisions of Article 6 (business profits) shall apply". In other words, the interest becomes business income liable to tax at both ends.

In the case of *royalties,* the right to tax is given in full to both parties.

Independent personal services are dealt with on pretty much the usual basis of taxability only in the home territory unless they are exercised in the other territory through a fixed base, in which case the right to tax is given to both.

Another major departure from usual practice, and this in deference to the "tax home" principle, is that

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salaries, etc., are taxable only in the State where the services are rendered. This in fact goes beyond the "tax home" principle as it does not necessarily follow in principle that employment income arises in the country where the services are rendered. The only exception to this unusual rule is that which states (as is normal) that emoluments earned in the field of international transport are only taxable in the state where the place of effective management of the enterprise is situated.

The provision regarding *directors' fees* is normal in that the country where the company is resident is given the right (but not sole right) to levy tax thereon. Artists and athletes may also be taxed in the country where their talents are exercised. On the other hand, pensions for past employment are only taxable in the country where the pensioner is resident. Remuneration paid in respect of Government functions is dealt with on the normal pattern. So also the income provided for students in respect of their studies, or derived by the students in connection with their studies.

Professors, teachers and *researchers* are dealt with rather harshly. Exemption in the state visited is only granted in respect of visits not exceeding three months. Although the Convention, rather ambiguously, then goes on to state that the three-month period may be extended by similar periods, the limited scope of the exemption renders it practically useless.

Double taxation is eliminated via the credit method. There is no distinction between any source or category of income. It is furthermore provided that if the law of either state provides for the granting of further relief beyond credit relief, then such relief can still be granted. Clearly, what the Convention has in mind here is a system which Malta had, but which has long disappeared from the statute book, to the effect that unrelieved foreign tax was to be allowed as a deduction in computing the income.

The Articles regarding *non-discrimination, mutual agreement procedure* and *exchange of information* appear to be in line with the normal provisions and need not be elaborated upon, saving to confirm that on at least one occasion the competent authorities of the two Contracting States did go through – with positive results – the full procedure of consultation and agreement, including the setting up of an ad hoc commission for the purpose.

USE OF THE CONVENTION BY NON-MALTESE

As already stated, the Convention, within its limits, is a working agreement between the two countries concerned, Malta and Libya. The question arises, however, whether the treaty can be used by residents of other countries as well. If this is at all possible it would appear to be in respect of Libyan taxation on income which may be made flow out of that country via Malta. Nothing useful would appear to be possible in the opposite direction, that is funds generated in Malta and repatriated via Libya. It will be noted that the usual Article 1 of a DTA, that is to say *personal scope,* is missing from the Convention. This could help in preparing the ground work for such an exercise.

Shipping

Perhaps the item of income which readily comes to mind is that arising from shipping in international traffic. In terms of the Convention, *shipping profits* are only taxable in the place of effective management of the relative enterprise. Shipping companies having contacts with Libya, could therefore register their ships under the Maltese flag via companies set up and "managed" in Malta. This should obtain exemption in Libya. Normally, of course, such exemption would merely transfer full liability to Malta: but in terms of Malta's Merchant Shipping Act, 1973, ships can be registered as exempt ships with the Minister of Finance.[1] This should obtain exemption both in Libya and in Malta. It will be observed that there is no limitation imposed in the Convention in respect of the exemption of Maltese companies' shipping profits from the Libyan end, such as exists in most of Malta's other double taxation treaties precisely because of the separate exemption given under the Merchant Shipping Act. This dual exemption seems to work well in practice, and there does not seem to have been any complaint from Maltese ship-owning companies to the effect that the dual benefit is being frustrated unilaterally in Libya.

Under the Merchant Shipping Act, the profits made by exempt Maltese companies can also be distributed by way of tax-free dividends without any time limitation whatsoever. It only remains to be seen whether these dividends can also be received tax-free by the ultimate recipient. This could happen in one of three alternative ways:

(a) by the recipient company being located in a tax haven country;
(b) the parent company being resident in a country with which Malta has a Convention stipulating that dividends paid by Maltese companies will not be brought to charge for tax; or
(c) the parent company being located in a country which, again via a double tax treaty, grants tax sparing relief in respect of Malta tax which is remitted under incentives legislation: there appears to be no reason why the Merchant Shipping Act in this respect should not qualify as an incentive legislation.

The circle is now complete and the shipping profits have escaped taxation at all levels.

The same operation cannot be made to apply in the case of air transport profits because there is no exemption for such profits under Maltese law equivalent to that granted to shipping under the Merchant Shipping Act, 1973. It may well be worth considering, however,

1. See article on Malta's Merchant Shipping Act in 40 *Bulletin for international fiscal documentation* 8/9 (1986) at 413.

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whether such profits should be removed from the Libyan tax area to that of Malta.

Business profits

Business profits earned in Libya are taxable in that country in the normal way. If earned by a Maltese enterprise, not through a *permanent establishment,* they should not be taxable, but normally the earning of relevant business profits in a country does require the existence of a *permanent establishment. Business profits* earned by Maltese enterprises in Libya are therefore taxable in the normal way. The tax suffered in that country is, however, allowable as a credit against the Malta tax payable. As the Libyan tax is usually somewhat higher than that payable in Malta, this effectively means that the Malta tax is wiped out, but the higher Libyan tax is suffered.

When dividends are distributed by the Maltese company the tax suffered by it (inclusive of tax payable, but remitted because of double taxation relief) is fully credited against the tax payable by the recipient foreign company. This effectively means that the profits earned in Libya suffer no Malta tax whatsoever. The workings are as follows:

		Lm
Libyan profits		1,000
Libyan tax at 40% (hypothetical)		400
Net profits to Malta		600
Maltese tax:	Net Libyan income	600
	Grossed up	400
		1,000
	Tax at 32.5%	325
	Double taxation relief	325
	No further tax payable	0
Net available for dividend		600
Grossed up at 32.5% when paid to foreign company		889
Malta tax thereon at 32.5%		289
Tax credit		289
No further tax payable in Malta		0

The situation in the country of residence of the recipient company must now be examined. The best situation would of course be in those countries where dividends paid by Maltese companies are not taxable. In that case, the Libyan tax would be the tax finally payable on the Libyan profits. If the recipient company is located in any other treaty country, it should be able to claim as relief the Malta tax payable on the dividend, that is to say 289 Lm as above. The final tax payable will in this case be the Libyan tax plus the amount of any home territory tax which is not relieved in respect of the Malta tax of 289 Lm.

Many of these problems and manipulations, not to say problematical manipulations, could be side-tracked if the trading in Libya is carried out by a tax haven company, in which case the Libyan tax would be the final tax payable. But tax haven profits some time or other will have to be repatriated, and although the resultant tax deferral is valuable, tax will eventually be suffered. Tax administrations are also continuously thinking up more ingenious ways of having a bite at tax haven profits. In any case, the advantages of tax deferral is not one of the themes of this article.

Dividends and interest

No similar benefits as those obtainable in a *permanent establishment* situation can be obtained by withdrawing the Libyan profits by way of dividends or interests from a Libyan company. First of all it is extremely doubtful in what circumstances the Libyan authorities would allow the setting up of a Libyan corporation. Moreover, the Convention reserves to Libya the sole right of taxing both these items of income. The crucial double taxation credit and the tax credit allowable on the distribution of dividends by the Malta company would both be absent.

Royalties

On the other hand, royalties derived from sources in Libya by a Maltese enterprise remain taxable in both countries. In this sense the income may be considered at a par with business income earned through a *permanent establishment,* and the procedures outlined above would also appear to be applicable. It is not, however, very usual to find royalties being paid from Libya.

Personnel

The provisions in the Convention regarding the taxation of income from dependent personal services (salaries, wages, etc.) often achieves importance. As already set out, liability arises solely in the country where the services are rendered. It follows that emoluments for work performed in Libya are only taxable in that country and not at all in Malta. One might well ask how does the latter country come into the picture. The matter arises because personnel stationed in Libya for long periods of time often desire to have their families living in a near country which is fairly stable politically and which offers most of the amenities that one normally expects from a home territory. Malta appears to be ideally situated for this purpose, but the tax authorities insist that in such circumstances some amount of Malta tax be paid. Under special provisions for salary income earned outside Malta, the tax liability in the country is drastically reduced, but in the case of income earned in Libya, liability in Malta simply does not arise in virtue of the double taxation convention.

No visa or residential problems arise in this regard. The situation is well recognised and although there is strict enforcement of the rule that foreigners cannot take up work in Malta, movement in and out of the country is in no way hampered. Ownership of real property is also possible and the operation of external accounts free of exchange control regulation is also available both in Maltese and in foreign currency.

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Non-discrimination and mutual agreement procedure

One final important point which must not be ignored is the existence of the Articles relative to *non-discrimination* and *the mutual agreement procedure*. Their existence in the Convention enables some measure of recourse to be had at Government level where agreement cannot be reached between the taxpayer and the Libyan authorities. The way in which the Libyan authorities impose the tax may not always be clearly understood, and recourse at official level may not have the desired results. At Government level and in the really important cases, however, some better measure of progress may be achieved. The Maltese tax authorities, whether at official or Government level, are of course always ready to help.

REVENUE CERTIFICATION

The relief to which a company or an individual (in cases of special reduced rates of tax) may be entitled do not operate by way of time-consuming and cost-expensive refunds. That is to say, the full normal Malta tax does not have to be first paid and then later refunded following appropriate claims and documentation. The tax is immediately relieved or held in abeyance if a prima facie case is submitted with the returns. Documentation will always be required so that definitive action can be taken, and it is obviously in the interest of the taxpayer concerned to make this available as soon as possible. One minor irritant in this respect is the system of Provisional Tax in Malta under which each taxpayer should pay once every four months on account of the current liability a tax calculated at one third of the last assessment received. No such tax will be payable in the cases contemplated, but computerized demands will normally still issue regularly. Arrangements can be made to have these demands withheld and, in any case, they should be ignored.

In extracting funds from Malta, Exchange Control authorisation is always necessary. The Exchange Control authorities may require endorsement by the Revenue, and until the system becomes one of well established routine, this may cause some time lag. The matter should therefore be one of the first points to be attended to and cleared up.

FINAL TAXATION ISSUES

The question of corporate taxation has been dealt with above. As regards personal taxation, it has been noted that emoluments for work performed in Libya are exempt in Malta. Personnel who have to perform functions elsewhere and who may remain taxable in Malta due to their having a place of residence in the country in which their families reside, and to which they periodically return, may have their tax reduced to as low as 300 Lm (say $ 800) per annum.

The company will also not be subject to any other sort of taxation in Malta except Income Tax within the context of what is set out in this article. In particular, there is no Value Added Tax or any similar imposition in Malta. The companies involved would, if at all, be subject to income tax with no complications regarding irrecoverable indirect taxation.

Should it become necessary to have personnel who are stationed abroad employed with a Maltese company, this can be arranged and any form of contract of service will be sufficient. If the employees have no connection with Malta as above contemplated they will not be subject to any Malta tax. In any case, however, no social security taxes will be payable either by the company or by the employees.

ADMINISTRATIVE ASPECTS

The setting up of a foreign-owned company in Malta requires the permission of the Central Bank, Exchange Control Division. This is readily granted. The minimum capital is 5,000 Lm, of which 20% must be paid up (say $ 2,700). This is available for the company's operations and need not be kept intact.

There is no requirement that any reserves be built up. Accounting is necessary in accordance with generally accepted accountancy principles, and annual filing is necessary with both the tax authorities and the Registrar of Partnerships. The company's auditors usually attend to these requirements.

The company's statute will be prepared by accountants or lawyers. Formation costs should be in the region of 400/500 Lm unless a much larger capital than the statutory minimum is required. Annual administration fees, including accounting, audit and directors' fees, should start from about 500 Lm, but will of course depend on the volume of business generated. Official dues are an annual registration fee of 25 Lm and any residual taxation. Bank charges should amount to about 0.35% on turnover.

When the company has exhausted its functions, it can be readily liquidated. As it will own no assets and should have few, if any, creditors and debtors, this should present few complications.

POLITICAL STABILITY

Trans-national operations such as are contemplated in this article are always subject to a consideration of the political stability of the countries concerned. This article cannot examine in depth the political situation in Libya. This matter will have to be gauged by each firm within the context of the activities it intends to carry out in that country.

As regards Malta, politically the country has moved during the past twenty-five years from being a Crown Colony administered directly by Britain to the status of a self-governing state with certain measures (e.g.

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foreign policy) still reserved to Whitehall, to the status of an independent monarchy acknowledging the British sovereign as its head of state, and finally to that of a republic, but still a member of the Commonwealth and of the United Nations. Of Malta's two political parties, the Nationalist Party which at the last elections secured an absolute majority of votes has now become a centre party, member of the Christian Democrat international movement. The Malta Labour Party, the Government in power, has moved from being a moderately socialist party towards more left-wing tendencies.

The developments in Maltese politics over the past few years have not lacked a certain amount of turbulence. This should not, however, cause any concern as regards the feasibility of any matter considered in this article. In particular, it has in no way affected the families of any personnel or foreigners stationed in Malta.

COMMERCIALITY

Any scheme intending to utilize the Malta/Libya Double Taxation Convention will obviously have to be planned to reflect sound commercial objectives although the underlying reasons will be tax motivated. Good international tax management requires nothing less. That the actual financial gains it is hoped to achieve should be carefully calculated need not be emphasized, though it is surprising how much effort is often spent on achieving negligible results.

To make good use of the Convention, however, sham structures must be avoided and it must be recognized that the substance of the transaction will often be given greater importance than its form. This may not be of great importance from the Maltese end where it will be readily accepted that tax saving is the primary aim but may be of vital importance in the home territory involved. Unnecessarily complex structures should therefore be avoided and sound business practices adopted.

Name plate corporations may not always be sufficient. Arm's length trading principles should be adopted wherever possible and proper documentation be available for scrutiny. Properly constituted directors' and shareholders' meetings should be held as necessary to satisfy home territory requirements. Although the company law of Malta may accept signed resolutions as valid in lieu of actual meetings, home territory requirements in this respect will have to be carefully considered and satisfied.

Conference Diary

FEBRUARY 1987

Institut für Auslandsbeziehungen: Seminar 2 – U.S.A. Stuttgart-Hohenheim, 16-18 February (German).

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

Seminar Services International: Holding and Finance Companies. Zurich, 16-17 March (English).

Institut für Auslandsbeziehungen: Seminar 3 – Türkei. Stuttgart-Hohenheim, 16-18 March (German).

International Chamber of Commerce: Symposium on Consequences for International Business of the U.S. Tax Reform. Paris, 23 March (English, French).

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).

APRIL 1987

McGeorge School of Law: Business Transactions and Investment in Asia and the Pacific. Waidring, 29 March - 4 April (English).

International Fiscal Services: Use and Recognition of Trusts in International Tax Planning. London, 10 April (English).

International Bureau of Fiscal Documentation: The First East-West Tax Conference. Salzburg, 14-15 April (English).

MAY 1987

U.S.A. Branch of I.F.A.: Spring Seminar of the I.F.A. U.S.A. Branch (North-east Region). New York City, 1 May (English).

Institut für Auslandsbeziehungen: Seminar 4 – U.S.S.R. Stuttgart-Hohenheim, 11-13 May (German).

British and Swiss Branches of I.F.A.: Joint Seminar. Lucerne, 21-22 May (English).

JUNE 1987

Legal Studies & Services Limited: Trusts for Europe. Amsterdam , 11-12 June (English).

Legal Studies & Services Limited: The Legitimate and Advantageous Uses for International Operations. Amsterdam, 15-16 June (English).

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INDIA:

Tax Approaches to Energy Management

By Har Govind

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INTRODUCTION

1. The four most important problems currently facing India are poverty, population, pollution and power. The first three are related with one another. Demographic studies have shown that poverty is one of the causes of population explosion. Again, poverty and over-population are two of the greatest risks to the environment. The fight against poverty is, therefore, the number one challenge in India. One of the effective instruments to alleviate poverty is the optimal development and consumption of electricity and other forms of power. Energy management is, therefore, directly linked with population control and provision of a better quality of life to the people.

According to recent estimates made by the Central Energy Advisory Board, the projected level of need of the three main sources of energy by the end of 2005 A.D. will be:

Coal	450 million tonnes
Oil	50 million tonnes
Power	654 billion units

Source: Hindustan Times: 27 September 1986.

The consumption of commercial energy may go up to 1485 MTCR (million tonnes of coal replacement). For reaching the above projected level, the domestic investment requirement has been estimated at 4,500,000,000,000 Rs. These figures highlight the vast opportunities available in the next 20 years in India's energy management programme.

ENERGY SOURCES

2. The major energy sources are classified into two categories – fossil fuels and the renewable resources. Coal, oil, natural gas, uranium and other nuclear fuels fall under the first category. Reserves of fossil fuels are limited and are depleting with exploitation. The renewable sources are biomass, hydro-electric power, sunlight, wind, tides and geo-thermal and ocean-thermal energy. It is well known that one form of energy is convertible into another. For example, heat is being converted into electricity and light. Even mass is convertible into energy. The conversion equivalence is represented by Albert Einstein's celebrated equation $E=mc^2$, which says that the energy (E) released in ergs by the conversion of one gramme of mass (m) is equal to the square of the velocity of light (c), that is $(3 \times 10^{10})^2$ or 9×10^{20} ergs, which is an enormous quantity of energy.

NEED OF INVESTMENT AND TECHNOLOGY

3. Energy management means achievement of predetermined objectives in generation, distribution and utilization of energy with the highest efficiency and economy. To begin with, a brief recapitulation of the problems relating to various aspects of energy management will assist in identification of areas, where application of tax reliefs may yield useful results. This may be followed by a detailed analysis of available tax reliefs, their shortcomings and the need for tax reform. The problems relating to major energy sources may now be listed.

(i) Coal

Presently coal mining is hazardous to human life. The Chasnalla mine disaster a few years back still haunts the miners. Improved mining techniques are necessary to increase coal production with lesser risk . To resolve transportation problems, construction of thermal power stations at pit heads, development of slurry pipelines, construction of coal washeries and conversion of coal directly into oil or gas need to be introduced in the coal mining industry with greater speed. These need enormous investment, continued research and modern upgraded technology.

(ii) Hydro-electric power

India ranks seventh in the world in terms of potential

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hydro-electric power resources. The running water for power generation is a renewable resource. A hydro-electric project is multi-purpose. It controls floods and helps irrigation. So far only about 20% of this potential has been exploited. Most of the hydro-electric projects are situated in difficult and inaccessible terrain. They are seasonal, involve high capital cost and a longer gestation period. The capacity utilization of existing power plants is low. An estimated increase of 10% in capacity utilization would be the equivalent of about 3,000 megawatts. This is within an achievable range with proper management and technological upgrading.

(iii) Oil and natural gas

At the present rate of extraction, most of the existing wells may dry up in the next 30 years or so. This calls for intensified effort towards fresh exploration for oil and natural gas both in on-shore and off-shore areas. It is also necessary to develop substitutes for petroleum.

(iv) Nuclear fuel

The development of nuclear energy requires, in addition to massive investment, considerable research and technology in mining, storing and activating nuclear fuels like uranium, plutonium or thorium. The safety aspect in and around a nuclear power station is also very important in view of some serious accidents in many countries including the latest at Chernobyl in the Soviet Union on 26 April 1986. The full impact of this disaster in terms of human misery is still being evaluated.

(v) Biomass

The use of biomass in the form of cow dung and farm wastes for the production of biogas for cooking, lighting, running flour mills, pumping water and working small generators is widely known. The main directions in which biomass technology needs further development are (i) construction of large community-size biogas plants and (ii) utilization of other material such as human waste, sewage wastes and weeds like hyacinth instead of animal dung to increase gas output.

(vi) Sunlight

The sun is for everyone. However, the major barriers to successful utilization of sunlight are (i) its rapid diffusion and its decrease in temperature before it reaches the earth, (ii) the difficulty of storage when the sun is not shining in the night or on a cloudy day. A large amount of investment and sophisticated research and technology is, therefore, necessary to utilize the sun's heat either directly or by converting it into electricity.

(vii) Other sources

Some other sources of energy which have been tapped to a limited extent are wind, tides, geo-thermal energy and solar energy available from the sea due to temperature gradients between the sea-surface and sea-depths. Their development on a commercial scale needs, apart from financial resources, a variety of technological skills.

TAX PROVISIONS

4. The Income-tax Act (ITA) contains a number of direct and indirect provisions to boost production of energy and energy conservation. These may now be discussed and analyzed to the extent they are relevant for the purpose of this article.

FOREIGN TECHNICIANS

5. S.10(6)(viia) of the ITA provides important tax relief for foreign technicians employed in India. The remuneration of an "approved" technician up to 4,000 Rs. per month for the first 24 months of his service in India is exempt from tax. Remuneration in excess of 4,000 Rs. per month is taxable. However, if his Indian employer pays tax (a) on the excess component during the first 24 months and (b) on the whole remuneration, thereafter, the tax paid by the employer is not treated as income to the technician. There is no tax on tax. The second exemption (b) is available for an additional period of 24 months immediately after the initial 24 months. He enjoys tax-free remuneration for a total period of 4 years. The exemption is total. The tax-free salary is not added to other taxable income, if any, even for rate purposes. The freedom from grossing up gives a substantial tax benefit quantitatively. For example, a tax-free annual salary of 120,000 Rs. at current tax rates is equivalent to a taxable salary of 188,000 Rs. The term "technician" as defined in S.10(6)(viiia) includes experts in mining and generation of electricity or any other form of power. S.10(6)(viia) also empowers the Government to include new fields in the definition of "technician" by issuing a notification. Presently, experts in distribution (as distinguished from generation), conservation or general management of energy (including electricity or any other form of power) are not included in the definition of a technician under S.10(6)(viia) or any notification issued under that section.

There is considerable loss of electricity when it is transmitted from hydro-electric or thermal power houses through high tension grids to consuming points. It is also well known that most of the State Electricity Boards are running at a loss and their losses are mounting year after year. The present section 10(6)(viia) was drafted before the energy crisis. The words "electricity or any other form of power" used in in the definition of a foreign technician are inadequate to meet the current situation. They need to be replaced to include the wider concept of energy management, that is, skill in generation, distribution and managerial capacity. This can be done by issuing appropriate notification under S.10(6)(viia).

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NEED TO ELIMINATE LITIGATION

6. In the recent past, there have been some court cases pertaining to the interpretation of the term "technician". For example, in the case of CIT v. Mosanobu Nakai (1974) 93 ITR 414 (Ker), a skipper of a fishing trawler was not treated as a technician by the Kerala High Court. Again, in the case of Emil Webber v. CIT (1978) CTR 630: (1978) 114 ITR 515 (Bom) and N. Sciandra v. CIT (1979) 118 ITR 675, the Bombay and Calcutta High Courts have not treated skippers as technicians for want of an employee-employeer relationship. Generally, foreign technicians expect a smooth relationship and do not wish to be involved in tax litigation. It is advisable in disputed or doubtful cases to request the Central Government to make use of its power to issue a notification to cover new areas. Defects in service agreements should also be removed before they are submitted to Government approval.

Foreign technicians can be involved in the following new fields in greater numbers:

(i) Exploration and development of domestic reserves of oil and natural gas in areas not covered by an agreement with a foreign oil company.
(ii) Substitution of costly and exhaustible sources of energy such as oil by new and renewable energy sources like "gasonol" or "oxinol" or by relatively abundant energy sources like coal.
(iii) Development of the Magneto Hydro Dynamic Device (M.H.D.) process to convert coal directly into electricity.
(iv) Development of India's extensive hydro-electric potential.
(v) Conversion of an abundant renewable energy source, namely, sunlight, directly into electricity.
(vi) Establishment of energy audit firms and consultancy services for energy management.
(vii) Various energy saving areas detailed later under the paragraph on "Opportunities for Energy Saving".

The above are some of the exciting new areas in which foreign technicians should be attracted by providing favourable working conditions and a balanced tax approach. The exemption limit of 4,000 Rs. per month was fixed more than 15 years ago in 1971. It has become outdated due to the rise in the cost of living. It should be revised upwards to 8,000 Rs. per month.

INVESTMENT FUNDING SCHEME

7. Hitherto, an investment allowance at the rate of 25% (35% for some select items) of cost of new plant and machinery was allowed under S.32A to certain specified business undertakings. The Finance Act has added a new S.32AB to the ITA outlining a new funding scheme in lieu of the investment allowance. A run-down of its main features is –

(i) All business and professional undertakings, including those owned by non-residents and foreign companies are eligible with certain exceptions.
(ii) Undertakings carrying on the business of generation and distribution of power or manufacturing energy saving devices are eligible to the benefit of this scheme.
(iii) A deduction of up to 20% of the profits of an eligible undertaking will be allowable, if such profits are deposited in the Industrial Development Bank of India under an interest carrying scheme framed separately; or if they are utilized to purchase new (second hand shall also qualify on satisfaction of certain conditions) machinery and plant. Office appliances (other than computer), machinery and plant installed in office premises and guest houses, road transport vehicles and plant and machinery availing of 100% depreciation in first year itself, are not eligible to the benefit of this scheme.

This funding scheme opens up new doors for tax planners. An efficient profit making undertaking can create additional assets every year of up to 20% of its profits. It can deduct 200% of the cost of the machinery from the profits – 100% under the funding scheme in one year and another 100% as depreciation over a period of time. Investment allowance was earlier denied to professionals. They can now maximize their tax opportunities. An energy management expert can install a computer or buy costly equipment. He can receive a tax benefit by writing off 200% of the cost of the computer or equipment.

Research and Development

8. The urgent need of scientific research hardly needs any emphasis. Continued research is necessary –

(i) to create or develop new sources of energy to replace fossil fuels like oil and coal,
(ii) to promote conservation of energy, and
(iii) to improve energy management techniques.

S.35 of the ITA contains the provisions for tax concessions and incentives in respect of expenditure on scientific research, which are as follows, namely:

(i) Revenue expenditures incurred by a taxpayer on scientific research related to his business are allowed as a deduction in computing the taxable profits. Further revenue expenditures incurred on payment of salary to research personnel or on material inputs during the period of three years immediately preceding the commencement of the business are regarded as having been laid out or expended in the previous year in which the business is commenced and, accordingly, qualifies for deduction against taxable profits in that year.
(ii) The whole of the capital expenditures (excluding cost of land) on scientific research related to the taxpayer's business are allowed as a deduction in the year in which it is incurred. Further, the capital expenditures incurred on scientific research related to the taxpayer's business during the period of three years immediately preceding the commencement of the business are regarded as having been incurred in the previous year in which the

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business is commenced and, accordingly, allowed as deduction in computing the taxable profits of that year.

(iii) Payments to approved scientific research associations, universities, colleges or other institutions to be used for scientific research are allowed as a deduction in computing the taxable income.

Even lump-sum payment to a private researcher for exclusive research has been held to be admissible by the Delhi High Court in the case of Crescent Capacitators vs. CIT (1984) 149 ITR 285 (Del). Industries and business houses should take advantage of this decision and the liberal provisions of S.35, particularly the allowance of capital expenditure in one year. The expenditure on research in the energy field gives accelerated tax benefits in the first year and gives recurring benefits in the form of higher energy yield or larger energy saving year after year.

MINERALS

9. A new S.35E in the ITA provides for the amortization of expenditure incurred wholly and exclusively on any operation relating to prospecting for specified minerals or on the development of a mine. The minerals have been specified in a new Seventh Schedule to the ITA also inserted simultaneously. The following minerals, which are useful for the generation of energy on a commercial scale are listed in the Seventh Schedule:

(i) Coal,
(ii) Lignite,
(iii) Uranium ores,
(iv) Uraniferous allanite,
(v) Uranium bearing tailings left over from ores after extraction of copper and gold, ilmenite and other titanium ores,
(vi) Monazite and other thorium minerals,
(vii) Shale.

The amortization is admissible only in the case of Indian companies and resident non-corporate taxpayers. Amortization is admissible in respect of expenditure incurred under specified heads after 30 March 1970 during the 5-year period ending with the year of commercial production. The amortization is admissible irrespective of the fact whether the operations turn out to be successful or they turn out infructuous or abortive. The amortization will be allowed in equal instalments over a 10-year period against the profits arising from the commercial exploitation of any mine of any of the specified minerals. The amortization is not allowable against any other income of the assessee. Where the instalment of amortization expenditure relating to a given year cannot be wholly absorbed by the profits against which the amortization is to be allowed, the unabsorbed amount will be carried over to the subsequent year. Such carry-over will be allowed only up to and including the 10th year as reckoned from the year of commercial production. If there is any unabsorbed amount at the end of the 10th year, it will lapse.

OIL AND NATURAL GAS

10. Until recently, exploration for oil and natural gas was done by two Central Government companies, Oil and Natural Gas Commission (ONGC) and Oil India Ltd. (OIL). A new Government company has been formed recently to develop and utilize gas resources. It is called the Gas Authority of India Ltd. (GAIL). To boost domestic production for meeting the rising demand and to save foreign exchange, the Government has decided to open prospective on-shore and off-shore areas to foreign companies. Two bids have already been held and some contracts have been entered into. In a third round initiated in January 1986 the Government has invited reputed international companies to bid for exploration in one or more of the 27 off-shore blocks. The new blocks offered are Saurashtra (1), Kerala-Konkan (8), Kaveri (5), Krishna-Godavari (7), Palar (2) and Mahanadi (4). The salient features of the new offer are: (i) seismic option, which would permit a contractor to relinquish an area if the results of the seismic survey did not invite him to begin exploratory drilling, (ii) the contracts would be on a production sharing basis, that is, ONGC or OIL would have a right to participate to the extent of 40% in the development and production of oil in case commercial discovery was made, (iii) there is no obligation for minimum expenditure commitment and no limit on minimum production for recovery of cost, (iv) bank guarantees for the entire commitment given by the contractor would not be insisted upon; only guarantees related to the annual work programme would be obtained, (v) in the event of oil being found the contractor would offer the entire cost-oil and profit-oil to the Government at international market prices; and (vi) there would be no royalties on production.

EXCLUSIVE ECONOMIC ZONE

11. Under S.3 of the Maritime Zones Act, the territorial waters of India broadly extend to a distance of 12 nautical miles from shore. S.7 of the Maritime Zones Act also makes provision for an Exclusive Economic Zone (EEZ) that broadly extends 200 nautical miles from shore. The Government of India has exclusive rights within the EEZ for the purposes of the exploration for exploitation, conservation and management of natural resources. It also has the exclusive right and jurisdiction to construct off-shore terminals, installations and other structures within the zone.

TAX INCENTIVES

12. Under the provisions of S.42 as amended by the Finance Act, 1981, foreign companies that enter into agreements with parties authorized by the Central Government such as ONGC, OIL or GAIL are entitled to avail of deductions, on a negotiated basis, in computing taxable income. The deductions shall be allowed as per liberal terms of the agreement and not

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as per general provisions of the ITA. Further, S.293A of the ITA now gives the Central Government the power to grant exemptions, rate reductions or other modifications to taxpayers with which it or an authorized party – such as the ONGC – has an agreement. S.239A covers agreements involving (a) the prospecting for or the extraction or production of mineral oils, and (b) the provision of services or facilities, or the furnishing of any ship, aircraft, machinery or plant – by sale or hire – in connection with prospecting for or producing mineral oils and employees of persons referred to in (a) or (b). S.24AA of the Companies (Profits) Surtax Act gives similar power to the Central Government to give similar concessions for foreign oil companies in respect of the surtax.

Under S.293A, the Government has notified a much lower income tax rate of 55% for foreign oil companies as against 65% for other foreign companies. It is likely to be reduced further by 5% to 50% only. The Government has completely exempted foreign oil companies from payment of the surtax.

DRAFTING CARE

13. For some foreign companies, home country tax liability is an important consideration. The definition of income under home country tax laws can be complex and tax benefits earned in India can be taken away at home, especially if there is no tax avoidance treaty with India. This difficulty can be reduced if agreements with the Government are drafted to allow foreign companies to meet their home law requirements. That will bring revenue gain for the companies without any revenue loss to India, and will lead to a more attractive investment climate.

RENEWABLE RESOURCES

14. While the search for additional quantities of oil should continue with unabated vigour, there is also an urgent need to accelerate the development and use of renewable energy resources and to promote their utilization. The renewable energy sources which have already been brought to the threshold of commercial use by Indian scientists and engineers include solar, biomass and wind energy. Some fiscal incentives to promote use of these non-conventional forms of energy are called for. The depreciation allowance on machinery or plant installed for manufacturing renewable energy devices and systems has been raised from 10% to 30%. Depreciation on renewable energy devices and systems used for business or profession will also be allowed at the enhanced rate. The depreciation has been raised to 30% by amending the IT Rules, 1962. For a full list, reference is made to Addendum I. The important items included in the list are solar collectors, cookers, heaters, driers, air-conditioners, stills, power generators and pumps based on solar, thermal or electric power, windmills, biogas plants and equipment for utilizing ocean waves and thermal energy. The rate of 30% is likely to be raised to 50% through the next amendment of the IT Rules. The amendment has become necessary due to the passage of the Taxation Laws (Amendment and Miscellaneous Provisions) Act, 1986. It has extensively amended S.32 relating to allowance of depreciation. Now depreciation will be allowed on blocks of assets in place of individual items of assets.

ENERGY CONSERVATION

15. Energy conservation does not mean reduction in energy use at the expense of economic growth. It only means that energy should be used in the most productive and least wasteful fashion. In quantitative words, the energy reduction should be in absolute terms, that is, measured with reference to "output per unit of energy consumed". Perhaps it is not widely known that an incandescent electric bulb is less energy efficient than a fluorescent tube, a fan at slow and top speed consumes the same amount of electricity and energy is lost due to "evaporation" when electric current flows from the power house to the home or the factory. Some of the important estimates of potential for energy saving in the industrial sector in India are as follows:

(i) In a thermal power plant, according to one estimate, roughly 70% of the energy produced by the burning of coal is lost in the air and the cooling towers. A new method known as Magneto Hydrodynamic Method (MHD) which converts coal directly into electricity reduces this loss to 35%.

(ii) India's Seventh Finance Commission has estimated that the aggregate loss in transmission and generation of power is about 20%.

(iii) Dr. Eng. Alfred Schraund, a West German heat energy specialist, has estimated that about 30% energy saving can be effected in the Indian textile industry by employing control equipment and energy saving devices and processes and by making the operators and technicians aware of the magnitude of the energy losses.

(iv) A survey of 1,200 industrial units conducted by the National Productivity Council in collaboration with the Petroleum Conservation Research Association has estimated that, on average, 15 to 20% savings in energy is easily possible without any significant investment.

(v) The potential for energy savings with process modifications is placed around an additional 15%. The R & D programmes that could be adopted in the long term are to yield a further 15% more energy savings.

(vi) As per the estimates of the Working Group on Energy Policy, the scope for energy conservation in industry is as much as 66TWH of electricity and 32.2 million tonnes of coal (excluding coking coal) and 3 million tonnes of furnace oil between now and 2000 A.D. cumulatively.

(vii) According to the Inter-ministerial Working Group

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on Energy Conservation the overall potential for energy savings in the industrial sector is around 11,000,000,000 Rs. per year at the moment. This is expected to go up to 27,500,000,000 Rs. per annum by the end of the Seventh Plan (1985-90) and reach 50,000,000,000 Rs. per annum by the turn of the century. A cumulative savings of 300,000,000,000 Rs. –350,000,000,000 Rs. can be made by effecting a one-time investment of around 10,000,000,000 Rs. in energy conservation measures in industry.

ENERGY SAVING IN OTHER COUNTRIES

16. Efficient use of energy provides multiple advantages both to industry and the economy. It helps cut down costs of production and raise levels of productivity in industrial activity. It also gives an added competitive edge to industrial enterprises in the domestic and international market. The economy benefits from being cost efficient. Energy savings on a national scale also go a long way in minimizing energy shortages and also making the best possible use of fossil fuels. A 10% saving in the energy consumed in India would more than make good the current energy shortages.

It was through concerted efforts at conservation of energy that the developed nations in general and the oil-dependent countries like Japan and France in particular were able to weather the oil crisis and even increase their national incomes. In the OECD countries for example, energy consumption per unit of Gross National Product (GNP) fell by 14% between 1973-81 while their GNP grew by 20%. In this process the share of oil and oil products in the total energy consumption basket was brought down from 53.3% to 46.4%. The performance of some of the industrial enterprises in these countries has been even more impressive. For example, the U.K.-based Imperial Chemical Industries brought down their energy consumption per unit of output by about 38% between 1973-81.

The scope for saving energy in the industrial sector is equally large. That a wide scope exists for conservation of energy in the industrial sector is obvious from inter-country and inter-firm comparisons of energy consumed per unit of specific industrial products. The comparison between India and the developed nations clearly proves this point.

Industry	*Unit*	*India*	*Developed Nations*
Iron & Steel	106 Kcal/tonne	8- 9.5	4 - 6
Cement	103 Kcal/kg	1- 4.4	0.6- 0.9
Aluminium	13 Kwh/tonne	16-20	13 -15
Pulp & Paper	Kg. steam/kg	12-15	5 - 8

Source: Energy Efficiency in Industry: Federation of Indian Chambers of Commerce & Industry, New Delhi

ICC SURVEY

17. Studies by the Commission on Energy of the International Chamber of Commerce disclosed an interesting story with respect to industrial energy conservation. In the chemical, cement and steel industries a remarkable reduction in energy in absolute terms has taken place since 1974, which has compelled the major oil exporting countries to halt the rising prices. The ICC survey reveals that during the past decade the reduction in energy has been mainly brought about with the existing capital equipment and minor substitution methods, and not through major plant replacements. What has been accomplished has been by raising plant efficiencies, changing processes, lowering simultaneous loading (maximum demand) thereby avoiding major capital expenditure. Another great reform achieved during the above period was flattening the load demand curve, through the introduction of "off peak rates" reducing the capacity of generating stations, which in the past had to cater to peak loads. In India, where the load factor is shockingly low, a similar reform is greatly overdue.

ENERGY AUDIT

18. The processes used by diverse industries are different, with no standard norms for energy consumption. It is, therefore, necessary to evolve standard norms by industries by introducing energy audit. This will help identification of areas where energy use is inefficient and induction of corrective measures. One of the factors which has helped the dramatic energy reduction in advanced countries is energy audit. Energy wastage and inefficiencies cannot be revealed completely in industrial plants without energy audits, which are now regular in the developed countries of Western Europe, Japan and the U.S.A. Like financial audits, energy audits are invariably carried out by independent consultants. Reputed energy consulting firms have staff experienced in the diverse fields of engineering. They also associate plant employees with the various phases of the audit. Theoretically, the audit assignment exercise then has the effect of creating energy consciousness, as has been the case in European, American and Japanese firms. A good audit firm also creates a system for their clients by which they can measure and monitor energy utilization.

An energy audit is generally on the following lines. The auditing firm (always with a liaison officer) first proceeds to collect the basic data. This procedure eliminates arguments as to plant performance. Then the team proceeds to record plant consumption section-wise, which process is sometimes complicated by the fact that the client has not installed adequate instrumentation. The team then goes to determine the manufacturing processes followed by the plant staff. Thereafter the team assembles the above data and makes a preliminary assessment of actual performance against performance feasible with revised production processes, minor plant alterations and minor layout changes, that is, on the basis of the existing plant facilities. The auditing team finally proceeds to assess the energy savings in financial terms which can be brought about by the above measures, that is, on a

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minimum expenditure basis, utilizing the existing plant facilities. An economic analysis is prepared for the client calculating expenditure against gains. In the case of reasonably well run firms, the savings are of the order of 10% to 15% of the total annual energy expenditure.

AUDIT FIRMS

19. The cadre of trained energy auditors in India is almost negligible. An energy audit is essential to identify critical areas of inefficient energy use and suggest remedial measures. It will be in the long-term national interest to organize consultancy firms of energy auditors. For this purpose the help of foreign experts may be needed. To encourage establishment of such auditing firms, foreign technicians employed in them may be treated as technicians for the purposes of S.10(6)(viia) of the Act. The new energy audit firms may be given total tax exemption in respect of their income for the first three years.

OPPORTUNITIES FOR ENERGY SAVINGS

20. Achieving these savings would necessitate concerted efforts in different directions or areas as well as substantial investment in certain cases. The broad areas or directions in which energy savings can be effected in industry are as follows:

(i) implementation of direct savings techniques that help to avoid waste and wasteful uses such as good housekeeping measures and regular maintenance;
(ii) adopting of total energy systems in industrial process such as co-generation and the integration of all thermal operations;
(iii) recycling of energy wastes through various waste heat recovery systems;
(iv) retro-fitting of old industrial machinery to achieve optimal energy utilization;
(v) improving efficiency of conversion of primary fuels into secondary forms of energy, ensuring the quality of energy supplied and minimizing transmission and transport losses;
(vi) adoption of material conservation measures to reduce the consumption of energy-intensive materials and the products alongwith recycling of materials and re-using of components;
(vii) adoption of preventive maintenance techniques to cut down the energy and material costs involved in routine overhauls and breakdowns;
(viii) instrumentation of industrial process to monitor energy use; and
(ix) intensive research on viable energy alternatives and less energy-intensive techniques.

ENERGY SAVING DEVICES

21. To encourage conservation, depreciation rates on energy saving devices used in business have been raised from 15% to 100%. For a full list of eligible energy saving devices see Addendum II. Some important items are specialized boilers and furnaces, instruments for monitoring energy flows, waste heat recovery equipment and co-generation systems.

In addition to 100% depreciation, import of certain energy conservation devices is also allowed under open general licence. Funds at a concessional rate of interest are also made available for replacement of old boilers by more efficient ones.

EFFECT OF 100% DEPRECIATION ON FUNDING SCHEME

22. The 100% depreciation gives substantial tax relief immediately in the year of installation itself. Higher depreciation allowance generates internal funds through tax saving. There are no restrictions on such funds. They may be used either for capital formation or for distribution of dividends. They are not blocked in reserves. This is a welcome initiative, but there is scope for further improvement. In this connection, it is necessary to recollect that an item of asset which is eligible for 100% depreciation in the first year is not entitled to the benefit of the investment funding scheme under S.32AB. By proper tax planning a taxpayer can recover 200% of the cost of the asset on which the depreciation rate is lower than 100%. On energy saving devices for which a maximum 100% depreciation is allowed in the first year itself, this benefit cannot be availed of. Thus, in the final count, energy saving devices are deprived of the tax planning opportunity to recover the 200% cost under the investment funding and depreciation schemes taken together.

To give the benefit of investment deposit scheme to energy saving devices and other high priority items of plant and machinery like those used in scientific research on which 100% depreciation or deduction is allowed in the first year itself, it is necessary to delete sub-clause (d) to clause (4) of S.34AB, so that such high priority plants and machinery also receive the benefit of the investment deposit scheme.

FOREIGN PARTICIPATION

23. Foreign collaboration in the manufacture of renewable energy devices or energy saving devices and the energy management field in general is welcome if it conforms to approved norms and is conducive to achieving technical efficiency and lower production costs. Foreign partners can either supply technical know-how or advice or provide foreign currency finance either in the form of an investment or loan. Massive financial outlay is required to harness energy from hydel, biomass, sunlight and other energy sources. This necessarily calls for a foreign exchange component. Royalties (including income by way of lump-sum consideration) and fees for technical services, dividends and interest received by foreign companies are now taxed under a simplified procedure

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with concessional uniform rates of tax, under S.44D, as read with S.115A of the ITA. The rates for royalties and technical fees is 30%, and for dividends and interest it is 25%. On the other hand, the rate on a foreign company is 65%. Foreign companies and non-resident individuals can also participate in India's energy projects including manufacture of renewable energy devices and energy saving devices by forming an Indian company. In fact, this is a more desirable approach in a long-term perspective. Formation of a foreign company is permitted with 40% equity participation. A foreign company can form an Indian company through its nominees (Solomon v. Solomon (1897) AC 22).

ENERGY TAXES V. TAX CREDITS

24. A favourite tool of economists for adjusting the demand for a commodity to its supply is the pricing mechanism. However, there are many constraints in using the pricing formulae. An alternative is taxation and subsidization. Commoner Barry in his article "A Reporter at Large" in the New Yorker, 2 February 1976, has estimated that one half of the energy currently used by Americans is wasted. According to him, of all the nations on earth, the United States of America is the largest consumer and the greatest waster of energy. In the U.S.A. the technique of levying a higher sales tax on energy wasting appliances such as stoves with pilot-lights, frost-free refrigerators, and dishwashers has been tried with varying degrees of success. Escalations of taxes are generally not welcome. The method of tax credits generally proves more attractive. President Carter's National Energy Plan (1977) included insulation tax credits for home owners amounting to 25% for the first $ 800 spent and 15% for the next $ 1,400. Better insulation reduces heat loss and saves on energy for heating homesteads in winter. In the State of Michigan, an attempt has been made by amending the property tax laws to remove some of the disincentives, a property tax is normally imposed on housing improvements. Public Act (No. 293) of that State completely exempts insulation, storm windows and other expenditures on energy savings of up to $ 4,000 from assessment for up to 3 years. The U.S. experience of tax credits for energy savings deserves to be tried elsewhere, both in the commercial and residential sector.

It is hoped the foregoing discussion will help increase the already growing awareness about energy conservation and the role that the new tax techniques can play in the emerging energy scene. Saving energy is considerably cheaper and environmentally safer than developing new supplies. Experts have estimated that the cost of saving a barrel of oil or the equivalent amount of electricity or natural gas is about half that of producing the same amount of new energy. (Cheaper Warmth: *New York Times,* 1 February 1977).

TAX REFORM

This study has brought out some ideas for simplification and rationalization of the tax regime pertaining to energy management. Some important ones may now be summarized for ready recapitulation:

(i) The definition of a "technician" in S.10(6)(viia) contains the expression "a person having specialized knowledge and experience in. . . generation of electricity or any other form of power". This definition is narrow and restricted. The words "generation of electricity or any other form of power" should be replaced by a more comprehensive field, namely "generation, distribution, conservation or management of energy".

(ii) The existing ceiling of 4,000 Rs. per month for an approved technician needs to be raised to 8,000 Rs. per month.

(iii) Instead of allowing disputes regarding status of foreign technicians to go to Courts, the Government should issue notifications in suitable cases under S.10(6)(viia) to remove the legal defects.

(iv) To assist foreign companies to avail of full tax concessions under the Indian law, collaboration agreements may be permitted to be drafted in such a manner as to meet the requirements of their home law.

(v) Energy audit firms should be fully exempted from tax for the first 3 years.

(vi) Energy saving devices should be given the benefit of the investment funding scheme in addition to 100% depreciation.

Tax credits are generally more popular as compared to higher taxes to curb excessive consumption or waste. It is, therefore, desirable to adopt a liberal approach of tax credits and incentives to achieve higher energy production and its efficient use.

ADDENDUM I

Renewable Energy Devices

(i) Flat plate solar collectors
(ii) Concentrating and pipe type solar collectors
(iii) Solar cookers
(iv) Solar water heaters and systems
(v) Air/gas/fluid heating systems
(vi) Solar crop driers and systems
(vii) Solar refrigeration, cold storages and air-conditioning systems
(viii) Solar stills and desalination systems
(ix) Solar power generating systems
(x) Solar pumps based on solar thermal and solar photovoltaic conversion
(xi) Solar photovoltaic modules and panels for water pumping and other applications
(xii) Windmills and any specially designed devices which run on windmills

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(xiii) Any special devices including electric generators and pumps running on wind energy
(xiv) Biogas plants and biogas engines
(xv) Electrically operated vehicles including battery powered or fuel-cell powered vehicles
(xvi) Agricultural and municipal waste conversion devices producing energy
(xvii) Equipment for utilizing ocean waves and thermal energy
(xviii) Machinery and plant used in the manufacture of any of the above sub-items. (Sub-item No. (xviii) is very important. It covers machinery to manufacture machines. Foreign technicians and foreign firms can render fruitful assistance in this area of comparatively higher technology to the mutual advantage of the host country and the foreign party.)

ADDENDUM II

Energy Saving Devices

(a) Specialized boilers and furnaces:
  (i) Ignifluid/fluidized bed boiler
  (ii) Flameless furnaces
  (iii) Fluidized bed type heat treatment furnace
  (iv) High efficiency boilers (thermal efficiency higher than 75% in case of coal fired and 80% in case of oil/gas fired boilers)

(b) Instrumentation and monitoring system for monitoring energy system for monitoring energy flows:
  (i) Automatic electrical load monitoring system
  (ii) Digital heat loss meters
  (iii) Micro-processor-based control systems

(c) Waste heat recovery equipments and co-generations systems:
  (i) Economizers and feed water heaters
  (ii) Recuperators and air pre-heaters
  (iii) Backpressure turbines for co-generation
  (iv) Heat pumps
  (v) Vapour absorption refrigeration system
  (vi) Organic rankine cycle power system
  (vii) Low inlet pressure small steam turbines
  (viii) Shunt capacitors and synchronous condenser systems.

(Machinery and plant used in the manufacture of the above energy saving devices seem to have been left out of this list, perhaps by oversight. The same should also be included to make them eligible for the higher depreciation of 100%.)

[continued from p. 64]

tion may arise. The resolution of this issue would hinge in large measure on the following:
(a) the extent to which the corporate veil may for fiscal purposes be lifted under International Law,
(b) whether the theory of limited or unlimited legislative fiscal jurisdiction is subscribed to. Arguably on the basis of the limited theory[64] of fiscal jurisdiction which requires a reasonable link for the exercise of fiscal jurisdiction – the jurisdiction over the subsidiary is not in the first instance a reasonable link for the purposes of incorporating the parent company profits,
(c) whether and related to the above, given intra-territorial enforcement, the view is taken that it is unjustified because of the level of connection with the foreign conglomerate as a whole.

(3) Although there is no rule of General International Law prohibiting discrimination in fiscal matters as such, discrimination of foreign companies by the use of the unitary method if established could hinder or inhibit international trade and investment. In this context the GATT regime,[65] for instance, could be of relevance. In this article, however, the impact of conventional International Law has not been considered.

(4) On the issue of confiscation in the extreme circumstance when unitary taxation has the effect of incorporating extra-territorial profits not properly attributable to the domestic subsidiary – there may be a prima facie case of confiscation. However, when the unitary method operates genuinely to attribute profits no confiscation arises. The fact that the profits do not arise locally and/or in the ownership of the subsidiary may well be symptomatic of careful tax planning by the conglomerate rather than anything else.

64. Op. cit. supra, note 37b.
65. See e.g. Article 111 of GATT and A.R. Prest "GATT and Company taxation" *BTR* 1977 at Page 201.

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The Andean Pact

By Edgar Naranjo L.

The Latin American countries, searching for economic social integration to solve the backward problems of the region and to overcome the impractical principles of the Latin American Common Market, signed on 26 May 1969, in Bogota, Colombia, the sub-regional integration of the Andean Countries' Pact.

The Andean Group Pact, also called The Cartagena Agreement, was signed originally by Bolivia, Colombia, Chile, Ecuador and Peru. Venezuela joined the Group in September 1973 and Chile left the Andean Group in 1977.

This Agreement was intended to promote the harmonious and balanced development of the members of the Andean Group by an equitable distribution of benefits that will lessen the disparities existing among them, to accelerate economic development and to increase the standard of living of the population through the application of specific measures, among others:

1. Harmonization of economic and social policies of the members of the group, parallel to the creation of the sub-regional common market.
2. Joint industrial programmings, to rationalize production by means of selective agreements in several industrial sectors, by assigning new projects to specific countries and providing special financing.
3. Customs-exemption programme for trade, to gradually eliminate import duty obstacles to sub-regional trade.
4. Establishment of a common external tariff which assures a sub-regional margin of preference.
5. Promotion of programmes to further agricultural development by several measures to pursue agribusiness projects by taking measures to increase agricultural trade, to create agriculture products and raw material information offices, to create an Agricultural Board and to approve Andean projects for the technology development of forest resources.
6. Channeling external and internal financial resources within the sub-region to provide financing for investments which are considered of priority in the sub-regional integration process.
7. Recognize and grant preferential treatment to Bolivia and Ecuador, because of their condition as less developed countries of the region, to attain an accelerated socio-economic development, which enables them to reach the level of countries with greater relative development through their effective and immediate participation in the benefits of industrialization of the area and of customs exemptions.

The implementation of the customs exemption programme and the creation of a common external customs border which will make it possible to attain a customs union while joint industrial programming will seek to make efficient use of the multiple advantages offered by the expanded market and the formation of the Andean industrial base.

The Andean Group as an organization is governed by a Commission, which is the highest-ranking body of the Group, and is composed of plenipotentiaries representing the Governments of Member Countries. Its basic functions are: to formulate general policies of the Agreement, to approve the guidelines required for coordination of development plans, to see to it that the obligations deriving from the Agreement are fulfilled, to approve, disapprove or amend the proposals from the Board, to appoint and remove members of the Board and to give instructions to the Board.

The Board is the technical and executive body, which is composed by three members appointed by the Commission, for 3 years. Its main objectives are to ensure that the Agreement is implemented and that the decisions (expression of the integrated will of the Member Countries) and mandates of the Commission are carried out, and to undertake studies and formulate proposals to the Commission about the channeling of public and private savings of the region, financing of trade between Member Countries and with others, measurements to favour capital flows within the region to direct the industrial, commerce and services development to promote the expanded market, and to take adequate measures for the application of special treatment to Bolivia and Ecuador.

The Economic and Social Advisory Committee and the Councils advise the Commission and the Board on the specific problems at their request.

In order to harmonize the social and economic policies for an equitable distribution of the integration benefits, the following fundamental mechanisms have been adopted:

- An agreement for avoiding double taxation.
- A common regime concerning foreign investment and loan capital, patents, trade marks, licences and royalties, that establishes basic dispositions as such that foreign enterprises must be transformed into national or mixed enterprises in accordance with the fixed schedule.
- A uniform regime for Andean multinational enterprises and for the treatment applicable to sub-regional capital, to enforce enterprises' activity creating Andean multinational enterprises, taking advantage from the enlarged market and the investment operations from the sub-regional integration system.
- Harmonization of industrial development policies through strategies to eliminate gradually exemptions, reductions and devolutions of import duties, according to the legislation of the Member Countries, to conform to a common external tariff and to promote exports, and industrial and production development programmes and of technology transferences.
- The common external tariff for members of the Andean Group facilitates the adequacy of import

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duties and the trade liberation programme and sectoral programmes of industrial development.
- Others, such as the temporary entrance of tourists' vehicles, free of charges and taxes, without any guarantee, to develop tourist activity.

Industrial programming gives special consideration to the Ecuadorian and Bolivian situation for priority assignation of products, location of plants in their territories and the establishments of exclusive advantages.

The objectives of industrial development programmes are to create a sub-regional industrial base with industries whose capital, occupied capacity, utilization of labour and use of appropriate technologies are such that they can suitably meet the requirements of all the users of the sub-region.

Ecuador's participation in the sectoral industrial development programmes has permitted the devise and establishment of new manufacturing plants designed to supply the Andean sub-regional market, taking advantage of and assimilating more advanced technologies which could hardly have been used for industries based in the national market.

Preferential treatment is implicit in all the mechanism of the agreements. However, the advantages granted to Ecuador may be summarized as follows:

1. Priority assignation of products.
2. Advance elimination of import duties and restrictions for products of Ecuadorian origin.
3. Programme which defers the elimination of customs duties for the opening of its market.
4. Extended term for the adoption of the common external tariff.
5. Financing by the Andean Development Corporation which is over and above the country's contributions to the capital of the corporation.

Ecuador was assigned, through Decision 120, the manufacture of automobiles with maximum 1,500 cc. cylinder capacity, and trucks with maximum 4.6 tons of gross vehicle weight. But Ecuador hasn't received the expected benefits since the automotive programme is under coproduction agreements with Venezuela and Colombia.

Through Decisions 28 and 137, Ecuador and Bolivia were assigned the manufacture of several products which are not produced in any country of the subregion and which have not been reserved for sectoral programmes. These products are totally exempted from duties and restrictions.

Through Decision 91 the Commission approved the sectoral industrial development programme of the petrochemical sector, and under Decision 146 the manufacture of several products of the metal-mechanism sector was assigned to Ecuador for export to the Andean Pact countries.

17 years after the signing of the Andean Pact, the Member Countries apply the rules at their convenience, individually. Due to this, in order to keep the Andean Common Market, it is imperative that this Agreement be restructured in accordance to reality.

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AUSTRALIA:

Business Tax Reform: Ending the Double Tax on Company Dividends

Statement of the Treasurer of 10 December 1986[1]

The Government is to proceed with its company tax reform ending the double taxation of dividends, but in a form more beneficial to the business community and investors generally than previously announced.

This reform – costing $ 300 million in a full year – will bring major benefits to the Australian economy as a whole and, in particular, small business and small investors.

In essence it involves a substantial reduction in tax on shareholders, complementing the $ 4.5 billion of personal income tax cuts introduced on 1 December this year and 1 July next year.

This new system of reduced taxes will provide increased incentive for all Australians and will therefore enhance the economic growth prospects of our nation.

Small business people will benefit because their effective tax rate will be reduced from as much as 78 cents in the dollar to no more than 49 cents in the dollar. At the same time the Division 7 undistributed profits tax is to be abolished.

Small investors will benefit because the old system, while taxing the dividends of all shareholders twice, disadvantaged less well-off shareholders relative to more wealthy shareholders.

On a broader economic scale the new system will greatly reduce the existing bias in the tax system favouring debt over equity (the bias came about because interest income was taxed once while dividends were taxed twice).

It will mean entrepreneurs and others trying to get new businesses off the ground should find it easier to raise equity finance.

Investors will find it relatively more attractive to invest money with these enterprises, rather than confine themselves to more traditional investments.

The new company tax system is formally known as "imputation" because when dividends are paid it imputes or allocates to individual shareholders the profits and tax paid by the company in which they own shares.

Removal of the double taxation of dividends was strongly recommended by both the major financial system reports carried out in Australia's recent history – Asprey (1975) and Campbell (1981) – and was further canvassed in the Draft White Paper on Tax Reform published last year.

The new system will operate so that tax paid at the company level is credited to shareholders.

This means that dividend income will be effectively tax-free in the hands of shareholders if it has already borne company tax at the company tax rate.

For instance, if a company makes a profit of $ 100,000 and as a consequence pays company tax of $ 49,000, it will be able to pass on tax-free dividends worth $ 51,000 to its shareholders.

Taxpayers paying less than the top marginal rate will not only receive such dividends tax-free, but will actually receive surplus credits which reduce the tax they have to pay on other income.

However, dividends paid from profits which have not borne company tax will not carry imputation credits and will remain taxable in the hands of shareholders.

This system differs from the original proposal announced in September last year which would have imposed a new compensatory tax on companies when they paid out dividends.

However, in discussions the Government has had during the past 12 months it has become clear that such an approach would disadvantage a number of industries, in particular mining and petroleum, by effectively increasing their tax liability and reducing their cash flow.

Also, in some cases it would have imposed an increased tax burden on Australian companies that receive income from abroad.

The new system will preserve all the benefits of the earlier proposal while at the same time eliminating detrimental side-effects.

The benefits to ordinary shareholders of the imputation system can best be demonstrated by a simple example which assumes that a company pays as dividends all its after-tax profits; for the purposes of the example we assume that the shareholder has sufficient other income so that he was paying tax at the top rate of 60 cents in the dollar.

The old system

Company profits	$ 1000
Company tax (46%)	– $ 460
After tax profits (paid as dividend)	$ 540
Tax paid by shareholder (60% of dividend) =	– $ 324
Shareholder's net company income	$ 216

1. Press release issued by the Treasury.

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In this case the shareholder's income has been taxed at an effective rate of 78.4 cents in the dollar. Even if the shareholder had a lower marginal rate, say 46%, the total tax on dividends would still work out at over 70%.

Under the new system the company tax rate will be aligned with the new, lower, top personal tax rate of 49%.

Then the $ 1,000 of company income referred to earlier will be taxed as follows:

The new system

Company profits		$ 1000
Company tax (49%)		– $ 490
After tax profits (paid as dividend)		$ 510
Dividend	= ($ 510)	
Credit for company tax paid	= ($ 490)	
Total value to shareholder	= ($ 1000)	
Shareholder's nominal tax bill (49% of $ 1000)		– $ 490
Credit		+ $ 490
Additional tax to pay by shareholder		zero
Shareholder's net income		$ 510

In this case the imputation credit eliminates any further tax on the dividend. Total tax is 49% instead of 78.4% under the old system. The shareholder is left with $ 510 instead of $ 216.

If the shareholder's marginal tax rate had been less than 49% (i.e., if the total taxable income was less than $ 35,000), the shareholder's tax credit would exceed the shareholder's tax liability on the dividend, and this excess credit could be used to reduce tax on other non-dividend income.

For example, assuming a taxpayer has a marginal tax rate of 40%.

Company profits		$ 1000
Company tax (49%)		– $ 490
After tax profits (paid as dividend)		$ 510
Dividend	= ($ 510)	
Credit for company tax paid	= ($ 490)	
Total value to shareholder	($ 1000)	
Shareholder's nominal tax bill (40% of $ 1000)		– $ 400
Credit		= $ 490
Excess credit		$ 90
Shareholder's net income		$ 600

In this case the imputation credit is larger than the shareholder's tax (because the shareholder has a lower tax rate than the company). The excess credit of $ 90 can be used to reduce tax paid on other (non-dividend) income.

However, if the shareholder has no other income on which tax is paid, a cash refund of the imputation credit will not be paid.

The key features of the new company tax system and related changes are summarized below; greater detail on the changes is provided in the Appendix.

Key features of the new system will be as follows:

- The earlier proposal to impose a compensatory tax on dividends when paid by a company will not be proceeded with.
- Dividends distributed by resident companies from 1 July 1987 will qualify for full imputation credits provided they are paid out of company income which has borne company tax paid at the 49% rate; these qualifying dividends will effectively be relieved of any further income tax in the hands of the shareholder.
- As previously announced, any credits in excess of that required to relieve dividends from income tax will be available to offset income tax on other income but no cash refunds of imputation credits will be allowed.
- In lieu of the compensatory tax arrangements, which would have imposed a new 49% tax on distributed income, dividends which are paid out of untaxed income (or income retained prior to 1 July 1987) will remain taxable as under current tax law – that is, they will be taxed at marginal rates when received by resident individuals.
- Qualifying dividends will be exempt from dividend withholding tax when paid to non-residents; however, dividends paid to non-residents out of company income which has not borne company tax will be liable for the existing 15% dividend withholding tax.
- Dividends received by companies from other resident companies will continue to be freed of company tax in the hands of the receiving company by the section 46 rebate. However, where such dividends are qualifying dividends (i.e. where they have already borne company tax at 49 cents in the dollar) the attached credits may be used to further credit dividends paid by the recipient company. That is, imputation credits may be passed through company structures to benefit ultimate individual resident shareholders. In effect this means that if a company receives a $ 51 dividend from another company, and company tax has already been paid in respect of that dividend in the hands of the first company, the second company can pass the dividend on to its shareholder(s) with $ 49 of imputation credits attached.
- The issue of bonus shares will generally be regarded as the payment of a dividend for the purposes of the imputation system and will be treated in the same way as other dividends under the tax law. This will mean that such issues will be subject to tax in the hands of an individual recipient and will carry imputation credits when eligible. (This provision will not affect pure share splits because they do not involve the creation of new share capital.)
- As previously announced, Division 7 of the Income Tax Assessment Act, which imposes a penalty tax on private companies which do not distribute a minimum proportion of their taxable income,

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will be abolished from 1987-88 subject to transitional rules.

The change to the new company tax system has necessitated a number of other measures, particularly to curtail tax avoidance opportunities.

Chief among these are further measures to curb the use of redeemable preference shares as a tax avoidance device and a new measure to prevent tax avoidance opportunities during the liquidation of companies.

Redeemable preference shares

The Government announced on 7 April 1986 that redeemable preference shares issued for an effective term of less than 2 years would be treated as debt for tax purposes; that meant that tax loss companies could no longer derive a tax advantage by issuing such preference shares at the expense of the revenue.

Since that date the Government has become aware of attempts to avoid the effects of this measure and while it is expected that many of these attempts will prove ineffective under general anti-avoidance laws, the Government has decided to further strengthen the law in this area.

In relation to all redeemable preference shares issued after 1 p.m. today, dividends on such shares will be treated as equity income but will not be eligible for the section 46 rebate when received by companies (i.e. such dividends will no longer be free of company tax when paid to a company).

Once the new tax system commences from 1 July 1987, the denial of section 46 eligibility for such dividends will apply only to those dividends paid out of income that has not borne tax at the 49% rate.

Liquidations

The Government has also considered the long-standing flaw in the tax law which allows certain profits derived by a company to be distributed free of tax during a company liquidation, even though such profits would have been taxable if paid out as a dividend at any time before liquidation.

Where liquidations commence after 1 p.m. today, any distribution on liquidation of amounts which are deemed as assessable income under the Income Tax Assessment Act and capital gains on assets acquired after 19 September 1985 will be deemed as dividends subject to tax (where applicable) in the hands of the recipient. The main effect of these changes is to treat capital gains which are made on assets acquired after 19 September 1985 (the commencement date of the capital gains tax) in the same way when distributed in liquidation as when they are distributed prior to liquidation.

The Government plans to introduce the legislation for these measures in the Autumn 1987 sitting of Parliament.

APPENDIX: IMPUTATION

The Government today announced the following details of the operation of the imputation system and related measures.

Qualifying dividends approach

Dividends paid by Australian resident companies after 30 June 1987 will continue to be assessable income in the hands of resident shareholders. Where dividends are paid out of company income which has borne company tax paid at the 49% rate, they will be relieved of further tax by imputation credits. Dividends paid out of such taxed company income are referred to as qualifying dividends (or "franked" dividends).

To establish whether dividends are qualifying dividends to which imputation credits are attached, companies will be required to establish and maintain a qualifying dividends account (QDA). This account simply records the amount of income retained in the company which has borne full company tax (payable generally after 30 June 1987 at the 49% rate). This amount will be calculated by reference to actual tax paid and the amount of any qualifying dividends a company itself receives from other Australian companies.

The amount to be added to the QDA in a year of income is therefore derived by the following formula:

$$[(^{51}/_{49})\ T + D]$$

where:

- T is the Australian company tax paid by the company in the relevant period;
- D is the amount of any franked dividends received by the company from other resident companies in the period; and

From the QDA will be deducted the cash amount of any qualifying dividends paid by the company, and the value of the imputation credits attaching to each dollar of dividends from the QDA will be calculated with reference to the prevailing company tax rate, i.e. $(^{49}/_{51})$ D where D is the cash dividend. Thus, at the 49% company tax rate, each $ 51 of franked dividend would have $ 49 of imputation credits attached.

The balance of the QDA will be calculated on an ongoing basis, with increments made as company tax (including instalments) is paid and franked dividends received and with deductions made as dividends are paid. A company will be allowed to carry forward indefinitely a positive QDA balance. Where a negative QDA balance arises and remains at the end of the year, a balancing payment will be required in the following year. In such cases, the amount of the balancing payment will be treated as a prepayment of a later year's tax and the company will receive a credit against company tax in a later year.

To avoid the need for complex adjustments, the QDA balance will be maintained on a wholly prospective basis. There will be no going back to frank or unfrank a dividend paid as a result of amendments made to a company's earlier tax

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assessments. Hence, where a company receives a credit amendment to a prior year assessment and an entitlement to a refund of tax, the QDA balance will be reduced by the amount of income reflecting the tax reduction and, as stated earlier, where a negative balance arises and remains at the end of the year, a balancing payment will be required. Where a company receives a debit amendment to a prior year assessment and is required to pay an additional amount of tax, the QDA will be appropriately increased. There will be no franking of unfranked dividends paid in the period prior to the debit amendment.

While the balance of the QDA will generally be calculated on an ongoing basis, at the time of the first dividend payment in a year by a company that reasonably expects to pay company tax or receive franked dividends later in the year, such companies will be allowed, at their option, to estimate the QDA credits expected by the end of that year and to frank dividends paid in that year accordingly.

Whether or not the QDA is based on estimated tax payable and franked dividends receivable, all companies will be subject to the following requirements:

- Companies will be required to balance their QDA at 30 June each year (or on the last day of their accounting year for some substituted accounting period cases). This reconciliation will be submitted to the Tax Office in the following year. For typical companies where the QDA balance was sufficient to cover all dividends paid, only details of entries made in the QDA would be required to determine the QDA balance to be carried forward to the next year;
- Where the total amount of actual QDA credits based on company tax paid and franked dividends received was less than the total amount of franked dividends paid, a payment would be required to restore the QDA balance to zero;
- This payment would be a non-refundable prepayment of company tax due in that or later years. This would, by reducing the company tax paid in that year, also reduce the amount credited to the QDA. Treating the payment as a prepayment of company tax would allow the full amount of company tax in that or later years to be creditable by non-resident shareholders against tax assessed on dividends in the relevant year under the foreign tax credit systems operating in their home countries;
- All dividends will be treated as being paid first out of the QDA (whether the actual QDA or that estimated under the arrangements outlined above). Only where the QDA balance is zero would unfranked dividends be payable (a relief will be granted where the QDA balance is so small that this requirement would be administratively onerous);
- Where a company has an advance and fixed commitment to pay dividends on particular classes of shares (e.g. preference share dividends) the company will be required, when paying dividends on any class of shares, to take those commitments into account in debiting the QDA and to pro-rate the QDA between the dividends payable on each class of share, whether payable immediately or later in that year; and
- Companies will be required to issue a dividend advice to their shareholders advising them of all details relevant to the dividend.

Method of tax relief for inter-corporate dividends

The section 46 rebate will continue to be the method of freeing from company tax dividend income of resident companies from other resident companies. The rebate is to be calculated on the basis of cash dividends received without setting off any associated expenses. This is the long-standing treatment sanctioned by the courts, and the treatment is consistent with imputation concepts.

Assessment of resident individuals

Franked dividends received by resident individuals from resident companies will confer a right to an imputation credit equal to 49/51 times the amount of the dividend. An amount equal to the dividend plus the imputation credit attaching thereto (called the "grossed-up" dividend; i.e. $ 100 for each $ 51 of dividend) will be included in the individual shareholder's assessable income. Personal tax will be assessed on taxable income and the imputation credit will be deducted from it. As the maximum marginal rate of personal income tax will be equal to the company tax rate of 49% from the date of introduction of imputation, the imputation credit will fully extinguish personal income tax on the "grossed-up" dividend and, for lower marginal rates, leave an excess credit. Excess credits can extinguish tax liabilities on non-dividend income including capital gains but will not be refundable in cash and cannot be carried forward to later years.

Treatment of dividends flowing through trusts and partnerships

The following treatment is to apply to achieve parity between individuals and companies who invest in shares directly and those who do so through a trust or partnership.

- Trust or partnership net income or losses are to be determined by grossing-up dividends by any attached imputation credits and subtracting allowable deductions.
- A resident partner or trust beneficiary entitled to a share of the partnership net income or loss or the trust net income will also be entitled to a share of any imputation credits attaching to the dividends. However, when a trust has a loss the imputation credits would be lost because such losses are not distributed to beneficiaries (consistent with the taxation treatment generally of trusts in a loss situation).
- For resident individual partners or beneficiaries, the relevant share of net income of the partnership or trust will be included, without any further grossing-up, in assessable income and the relevant share or partnership losses will be allowed.
- Were resident company partners or beneficiaries, however, to attract the section 46 rebate on their share of *grossed-up* net income they would be advantaged relative to a company investing in shares directly and attracting the section 46 rebate on cash dividends only. Similarly, company partners would be relatively disadvantaged were they to receive a share of partnership losses determined after taking into account grossed-up dividends. For resident company partners or beneficiaries, therefore, their share of net income will be reduced and their share of partnership losses will be increased by an amount equal to their share of imputation credits.

Medicare levy and separate net income

- The Medicare levy will be imposed on the grossed-up (and not the cash) dividends received.

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- Excess imputation credits will not offset the Medicare levy.
- Imputation credits will not be included as part of separate net income for dependant rebate purposes.

Co-operatives

Co-operatives doing 90% or more of their business with members are subject to Division 9 of the Income Tax Assessment Act and their dividends are deductible from their taxable income. There is already no double tax on those dividends. Consequently, the following treatment will apply to co-operative companies:

- Co-operatives are to be subject to the new tax rate of 49%.
- Imputation credits will not be allowed on dividends received by members from co-operatives subject to Division 9 (i.e. doing 90% or more of their business with members).
- Consistent with the recommended method of tax relief for inter-corporate dividends, the section 46 rebate will continue to free from company tax dividends received by co-operative companies from non-co-operative companies.
- Co-operatives which do not meet the requirements of Division 9 will be required to establish a QDA from which franked dividends may be paid. The QDA balance will be allowed to carry over to other years in which the Division 9 requirements are not met but franked dividends may not be paid from the QDA in years that the Division 9 requirements are satisfied.

Bonus issues

Post-30 June 1987 bonus issues, except those paid out of a genuine share premium account, are to be treated as dividends (required to be distributed first from the QDA) and to be assessable in the hands of individual shareholders who also would receive any imputation credits in respect of the bonus issue and gross up the amount of the bonus issue by the imputation credits in determining assessable income. For CGT purposes, the cost base of the bonus shares is to be their paid-up value, with indexing applying from the date of bonus issue. The date of acquisition will also be the date of issue, so that such shares will be subject to the CGT provisions irrespective of the date of acquisition of primary shares.

Partly paid bonus shares

The Government has decided to amend the provisions of the capital gains tax (CGT) legislation as they relate to partly paid bonus shares to close a potential avenue for CGT avoidance.

Where shares were acquired before 20 September 1985, the issue of partly paid bonus shares in relation thereto represents a potential device to confer CGT-exempt status upon new investments made after 19 September 1985, viz shareholders' payments of calls of capital in respect of such partly paid bonus issues.

The proposed amendments apply only to partly paid bonus shares acquired in respect of original shares which were acquired prior to 20 September 1985. The following revised arrangements are to apply to such shares issued after 1 p.m. today and before 1 July 1987.

- Until a call payment is made, the date of acquisition of partly paid-up bonus shares will continue to be taken as the date of acquisition of the original shares. When a call is subsequently paid by the shareholder receiving the partly paid bonus shares, the date of acquisition will thereupon be deemed to change to the date on which expenditure of the first call payment is incurred.
- There will be no need to determine the cost base prior to a call being made as the bonus shares will be exempt from CGT (the original shares being acquired prior to 20 September 1985). When a call payment is subsequently made by the recipient shareholder, the cost base of the partly paid bonus shares will be taken as the sum of their market value immediately before the date of the first call payment and the amount of that call payment. (Any subsequent call payments would, of course, add to the CGT cost base).

Partly paid bonus units in unit trusts

A similar circumvention of the rule that the CGT is to apply to new investments after 19 September 1985 could arise if partly paid bonus units that resulted in no amount being included in the assessable income of the recipient unitholder were issued by unit trusts to unitholders who acquired units before 20 September 1985. Accordingly amendments are to be made, along the lines outlined above for partly paid bonus shares, as follows.

- The date of acquisition of partly paid bonus units acquired for no consideration by virtue of an existing unitholding which was acquired before 20 September 1985 will continue to be taken as the date of acquisition of the original units until a call payment is made; when a call is subsequently paid by the unitholder receiving the partly paid bonus issues, the date of acquisition will thereupon be deemed to change to the date on which the expenditure on the first call payment is incurred.
- Once a call is paid by the recipient unitholder, the CGT cost base of the partly paid bonus units is to be taken as the sum of their market value immediately before the first call payment and the amount of the call payment.

These amendments will apply to all partly paid bonus units issued after 1 p.m. today where no amount of the issue is included in the assessable income of the recipient unitholder. For partly paid bonus units issued after 19 September 1985 but on or before 1 p.m. today, the arrangements in force at the date of issue would apply.

Distributions on liquidation

Deemed dividends under section 47(1), which would be required to be paid first from the QDA and when paid from the QDA would attract imputation credits, will be extended for liquidations commenced after 1 p.m. today to include distributions of all amounts which are assessable under any provision of the Income Tax Assessment Act and capital gains on assets acquired after 19 September 1985. In accordance with the changed treatment of bonus issues the amount of all bonus issues will be included in the paid-up capital of the issuing company and hence treated as return of capital on liquidation by amending section 47(3).

Dividend withholding tax and branches of non-resident companies in Australia

Dividends paid on or after 1 July 1987 to non-residents from the QDA are to be exempted from DWT and freed from

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tax by assessment. DWT will remain payable in respect of dividends paid from unfranked income (but this compares very favourably with the previously announced intention to apply 49% compensatory tax to such dividends).

Dividends paid on or after 1 July 1987 to non-residents with permanent establishments in Australia will be freed from tax by assessment, by formally removing their present exemption from DWT. Consistent with dividends paid to non-residents generally, dividends paid out of taxed income will not attract further tax in the hands of the branch, and dividends paid out of tax-preferred income will attract DWT.

As previously announced, branch profits tax will be abolished on income of the 1986-87 and subsequent years.

Anti-avoidance provisions

It is intended that anti-avoidance provisions will be included in the imputation legislation. These provisions will include measures to:

- prevent dividend stripping arrangements;
- deny the rebate of tax on intercorporate dividends to a private company incorporated acquired or revived after 1 p.m. today in respect of private company dividends received from a related private company after that time and not distributed to individual shareholders by 1 July 1987; and
- counter other avoidance arrangements.

Further details will be available when the legislation is introduced.

Preference shares

All redeemable preference shares (irrespective of term) and similar equity instruments issued, or used in financing arrangements entered into, after 1 p.m. today are to be treated as equity for income tax purposes. However, the section 46 rebate will be denied in respect of all dividends on such shares paid before 1 July 1987 and all non-qualifying dividends paid on such shares on or after 1 July 1987.

Pre-imputation profits

Pre-imputation profits distributed as dividends will attract tax in the hands of resident individuals. For dividends out of taxed income that results in a second layer of tax; for dividends out of income not bearing company tax it is the only layer of tax. This treatment reflects the prospective nature of the imputation system.

Foreign tax credits

Under current arrangements, foreign-source income passing through an Australian company to its resident individual shareholders is effectively freed from tax in the hands of the company and is taxed once in the hands of the shareholders at their marginal tax rates. This same outcome will continue to obtain under the combination of the foreign tax credit system and the full imputation system (i.e. one layer of Australian tax at the shareholder's marginal rate).

QDA balances will be determined only on the basis of Australian company tax paid. Creditable foreign tax will be allowed to be offset against Australian company tax assessed on foreign-source income, but will not be taken into account in determining the QDA balance. Any Australian company tax payable after taking into account any foreign tax credit will be taken into account any foreign tax credit will be taken into account in determining the QDA balance.

For tax-exempt shareholders or other shareholders unable to take full advantage of available credits, the QDA approach will provide a more favourable outcome than the compensatory tax approach. There will be no compensatory tax arising which is uncreditable for these shareholders. This will alleviate one of the most frequently expressed concerns about the foreign tax credit system.

Commencement arrangements for companies with substituted accounting periods

Company tax payments will generally commence at the 49% rate from 1 July 1987. However, those companies using a substituted accounting period which are subject to the 1986-87 Budget measure requiring an earlier instalment of tax will be able to apply that instalment to the calculation of the QDA for dividends paid after 30 June 1987. Only tax at the 49% rate will be allowed to determine the QDA balance.

Public unit trusts

Those corporate unit trusts and public trading trusts which are taxed as companies will also be subject to the imputation arrangements.

Termination arrangements for Division 7

For anti-avoidance reasons, Division 7 will last apply to the 1985-86 income year for income other than private company dividends.

Division 7 and related provisions of sections 46 and 46A will continue to apply to private company dividends paid after 30 June 1986 during a prescribed period that ended or commenced in the 1986-87 income year in order to prevent an indefinite halt to the flow of private company dividends to individual shareholders at the expense of the revenue. A private company that pays prescribed dividends to another private company would be required to inform that company that the dividends are subject to the transitional arrangements. In keeping with the intention of the measures, these dividends will pass through the corporate sector as unfranked dividends and be taxed in the hands of individual shareholders.

System for collecting company tax

The present instalment system for collecting company tax will continue to operate as at present.

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SINGAPORE:

Tax Incentives to Become a Financial Centre

By Lee Fook Hong, FCIS, FAIA

Mr. Lee is a Chartered Secretary and Management Consultant in Public Practice.

INTRODUCTION

Eight years ago, in 1978, the International Bureau of Fiscal Documentation collected a number of country surveys and published them under the title "Fiscal Policy and Tax Structures in Australasia" in Vol. V of "Studies on Taxation and Economic Development" (1978) for use as panel papers at the Seminar at the 32nd Congress of the International Fiscal Association held in Sydney.

In the country survey paper on Singapore, fiscal policies, development programmes and many other related issues were dealt with. "To promote Singapore as a Financial Centre" was then listed as one of the major economic development policies of the Government (Lee Fook Hong's Country Survey on Singapore in "Studies on Taxation and Economic Development" Vol. V, p. 121 (1978)).

After eight years, the policy of the Government remains unchanged. Since 1980, the Minister for Finance has been focusing attention in each year's Budget Speech with the goal to promote Singapore as a financial centre. More and more tax and non-tax incentives have since been made available to both local and foreign investors under tax legislation and through various government departments and agencies.

This paper will discuss the major tax incentives granted for Singapore's development as a financial centre. Some disincentives are also discussed.

Author's note:

This paper contains a few sections of a manuscript which is part of a larger research project. The initial research for the manuscript was undertaken while the author was involved in a research project in the School of Management Graduate College at the University of East Asia, Macau.

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Notwithstanding all the guidance and assistance, any errors or faults are attributable solely to the author.

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TAX INCENTIVES

Generally, a tax incentive is a concession which eliminates, minimizes or defers the tax burden otherwise imposed by the general principles of tax laws. It offers an investor an opportunity for tax savings and thus a higher rate of return on investment. In this regard, tax incentives play an important role in improving a country's investment climate.

Below are some of the more important tax incentives which have been introduced from time to time to stimulate the growth of the banking and financial services sector in Singapore.

A. Exemption of interest received from approved banks or approved Asian Dollar Bonds by non-residents

Interest received by a non-resident individual or a non-resident enterprise (which does not carry on business in Singapore and has no permanent establishment in Singapore) on deposit in an approved bank or from approved Asian Dollar Bonds are exempt from tax. These incentives, on the one hand, attract foreign funds for the banks and on the other hand assist the banks in negotiating lower interest rates with the foreign customers.

B. Concessionary rate of tax for Asian Currency Unit income

An Asian Currency Unit (ACU) is a separate bookkeeping unit set up by a bank, under special licence, for Asian Dollar transactions.

To encourage greater participation in the Asian Dollar Market by financial institutions, a tax incentive in the form of a concessionary rate of tax of 10% on income derived from "offshore" loans was introduced for the ACUs. This concessionary rate of tax was later extended to income derived by an ACU from advising or confirming "offshore" letters of credit. The range of qualifying "offshore" activities has subsequently expanded. Such activities are specified in the Income Tax (Concessionary Rate of Tax for Asian Currency Unit Income) Regulations, 1979, as amended.

The net qualifying income derived by an ACU less the 10% tax may be distributed to shareholders of the bank in the form of exempt dividends. Where the shareholder is a holding company owning not less than 50% of the beneficial interest in the issued capital of the bank at the time such dividends are received, the holding company may in turn distribute the exempt dividends to its shareholders. Such dividends will be exempt from tax in the hands of the shareholders.

C. Exemption of income arising from syndicated offshore loans

A special tax holiday scheme was introduced in 1983 to promote international loan syndication activities for further development of Singapore as an international financial centre. Under this scheme, tax exemption is given to income derived by an ACU from an approved syndicated offshore loan where the agreement for the loan is made at any time during a five-year period commencing 1 April 1983. The following conditions must be satisfied in order to qualify for this incentive scheme:

(i) there are at least three lenders;
(ii) the lead manager is an ACU of a financial institution in Singapore, or where there are two or more lead managers, at least half of that number should be financial institutions in Singapore;
(iii) the syndication process is carried out substantially in Singapore; and
(iv) the loan is an offshore loan.

In 1984, this tax holiday scheme was extended to include the syndication of guarantees, performance bonds and certain underwriting facilities, such as underwriting of bonds, floating rate notes and revolving underwriting facilities. In the case of underwriting, the tax exemption does not cover income earned by the underwriter arising from the holding of part of an issue that has not been fully subscribed.

The current scope of this incentive scheme is governed by the Income Tax (Income from Syndicated Offshore Credit and Underwriting Facilities) Regulations, 1986. The Regulations also extend the incentive scheme for a further five years ending 31 March 1993.

The exempt income derived by an ACU may be distributed to shareholders of the bank in the form of exempt dividends. Where the shareholder is a holding company owning not less than 50% of the beneficial interest in the issued capital of the bank at the time such dividends are received, the holding company may in turn distribute the exempt dividends to its shareholders. Such dividends will be exempt from tax in the hands of the shareholders.

D. Tax incentives for offshore fund management

To assist the development of Singapore as a fund management centre, an incentive scheme was introduced whereby investment gains from funds managed on behalf of a non-resident investor by ACUs are exempt from tax. In addition, the fees derived by the ACUs from providing such fund management services are accorded the 10% concessionary rate of tax. When this scheme was first introduced in 1983 one of the conditions attached was that the funds had to be invested overseas. Following representations from the fund management community for greater flexibility to further stimulate fund management activities in Singapore, the Government has now extended the scheme to include the following:

(a) the funds may be invested in local stocks and shares; and
(b) fund managers who do not have an ACU licence, but are approved by the Monetary Authority of Singapore, may participate in the scheme.

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Previously, the foreign investors were required to make a signed declaration of their non-resident status. This has now been abolished. Instead, the fund managers will have to affirm the non-resident status of their clients.

This incentive scheme does not cater to a non-resident institutional investor which has a permanent establishment in Singapore or carries on business in Singapore by itself or in association with others. In this respect, uncertainty often arises when a non-resident institutional investor has incidental interests in Singapore. The shift in the onus of affirming the non-resident status of the investors does not seem to have removed this uncertainty. However, it is understood that the fund managers would be absolved from any responsibility if an affirmation were made in good faith.

E. Concessionary rate of tax for income from insuring and reinsuring offshore risks

To stimulate re-insurance activities in Singapore, the Government introduced a tax incentive whereby gains or profits derived by an insurance company from the reinsurance of offshore risks are taxed at a concessionary rate of 10%. This incentive was extended in 1980 to include the insurance of offshore risks. The current scope of this incentive is governed by the Income Tax (Concessionary Rate of Tax for Income from Insuring and Reinsuring Offshore Risks) Regulations, 1980.

The income of an insurance company qualifying for the 10% concessionary rate of tax includes:
(i) income from accepting general *insurance* covering offshore risks;
(ii) income from accepting general *reinsurance* covering offshore risks; and
(iii) dividends and interest from the investment of its income arising from its business of *insuring* and *reinsuring* offshore risks.

"Offshore risks" is defined by Section 26(5) of the Income Tax Act (Cap 141) to mean:

> any risk outside Singapore and –
> (a) in relation to direct general insurance or facultative general reinsurance the insured is not a person resident in Singapore or a permanent establishment in Singapore; and
> (b) in relation to treaty general reinsurance not less than 75% of the total risk in terms of gross premiums is outside Singapore,
> and where any such risk is in transit in Singapore it shall be deemed to be outside Singapore.

The net qualifying income derived by an insurance company less the 10% tax may be distributed to the shareholders in the form of exempt dividends. Where the shareholder is a holding company owning not less than 50% of the beneficial interest in the issued capital of the insurance company at the time such dividends are received, the holding company may in turn distribute the exempt dividends to its shareholders. Such dividends will be exempt from tax in the hands of the shareholders.

F. Concessionary rate of tax for income from gold bullion, gold futures and financial futures

In 1981, a 10% concessionary rate of tax was given to income from offshore gold transactions derived by an approved member of the Gold Exchange of Singapore.

With the establishment of the Singapore International Monetary Exchange (SIMEX) in late 1984 to spearhead the development of financial futures trading, the scope of the above incentive is now governed by the Income Tax (Concessionary Rate of Tax for Income from Gold Bullion, Gold Futures and Financial Futures) Regulations, 1985. These regulations provide the 10% concessionary tax rate for income of corporate members of SIMEX arising from transactions with non-residents, ACUs and other SIMEX members.

The net qualifying income less the 10% tax may be distributed as exempt dividends to the shareholders of the institutions. Where the shareholder is a holding company owning not less than 50% of the beneficial interest in the issued capital of the bank at the time such dividends are received, the holding company may in turn distribute the exempt dividends to its shareholders. Such dividends will be exempt from tax in the hands of the shareholders.

As a further incentive for the futures market, SIMEX itself is given a five-year tax exemption on its income derived from futures activities.

G. Other tax related incentives

Other tax related incentives which were introduced over the years to assist the development of the financial sector in Singapore include the following:

1. Stamp duty exemption on
   - Asian Dollar Bonds
   - ACU Offshore Loan Agreements and all other related documents
   - cheques, including traveller's cheques
2. Estate duty exemption on the following property passing on death of a person who at the time of his death is neither resident nor domiciled in Singapore
   - deposits and balances with ACUs of approved banks
   - negotiable certificates of deposits issued by ACUs of approved banks
   - approved Asian Dollar Bonds
   - deposits and balances in gold savings accounts with approved banks
   - deposits and balances with members of SIMEX where such deposits and balances are in respect of qualifying transactions
3. Tax incentives for the ailing hotel and property sector, the stability of which has a fundamental bearing on the banking and financial services sector
   - property tax rebates

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- property tax exemption for property under development

4. 10% concessionary rate of tax for certain income derived by operational headquarters, including income derived from fund management and treasury functions.

H. Tax incentives for economic development

Tax incentives for economic development which directly or indirectly help to develop Singapore into a financial centre are available under the Income Tax Act, and the Economic Expansion Incentives (Relief from Income Tax) Act. There are other non-tax incentives such as the Capital Assistance Scheme, Small Industries Finance Scheme, Export Credit Insurance, Export Finance and Investment Guaranties.[1]

TAX INCONGRUITIES

Whilst Singapore has developed itself into a sophisticated financial sector, it still has much to attain before it becomes the "financial supermarket" as envisaged by the Government.

The tax incentives for the banking and financial services sector have been supportive and fruitful. However, there are a few incongruities existing within the local tax system which hinders the growth of this sector. The removal of these incongruities will assist Singapore in achieving more rapidly its goal of becoming a premier financial centre.

A. Taxation of interest income derived by resident individuals

Deposits with the Post Office Savings Bank of Singapore (POSB) have increased significantly over the years. The main reason for the increase is that interest income derived from any savings account with the POSB is exempt from tax, while interest income derived from other approved banks and financial institutions by resident individuals is not tax-exempt. The other banks and financial institutions have therefore experienced difficulty in mobilizing funds.

The taxation of interest income derived from Singapore by a resident individual also adversely affects local private capital formation since the tax burden discourages local savings and causes an outflow of capital funds.

A tax exemption of interest derived from banks and finance companies by resident individuals ought to entice the repatriation of capital funds back to Singapore and place the banks and finance companies on an equal footing with the POSB with regard to funds mobilization. Alternatively, a final withholding tax at a low rate of, say, 5% to 10% instead of the normal rate of 33% on such interest income may perhaps be helpful.

B. Taxation of remittances of foreign income

The scope of taxation in Singapore is territorial. Foreign income is not liable to tax in Singapore unless such income is remitted to Singapore by a taxpayer resident in Singapore for tax purposes. This system of taxation tends to suppress the local supply of investible funds since investors are reluctant to repatriate funds from their home country.

The Minister for Finance is empowered under the Income Tax Act (Cap 141) to exempt from tax wholly or in part foreign income received by a resident in Singapore (Section 13(7) of the Income Tax Act). Investors and financial entrepreneurs would certainly appreciate more flexibility and expediency on the part of the Ministry of Finance in processing applications for exemption from tax on remittances of foreign income. Ideally, a blanket exemption should be given on all foreign income remitted to Singapore, as recommended by the Economic Committee in its report in February 1986.

Until such tax exemption on remittances of income is introduced, there should be flexibility and closer coordination between the Ministry policy decision makers and the Revenue officers in dealing with applications for exemption under Section 13(7). Consistency in their objectives and flexibility in implementation should be maintained to eliminate unnecessary delays which may result in scaring away important investors.

C. Withholding taxes on interest derived by non-residents

Except for interest derived from deposits in approved banks and from approved Asian Dollar Bonds, interest derived from other transactions by non-residents is generally subject to withholding tax of 33%.

The abolition of these withholding taxes, especially on interest arising from debt instruments, margin deposits and gold transactions would serve to stimulate the development of the financial and commodity futures markets.

D. Taxation on income derived from third country trading

Third country trading provides the banking and finance sector with invaluable trade-related business opportunities, such as loan financing and credit financing businesses.

Income derived by an enterprise from third country trading in Singapore is considered to be sourced in or derived from Singapore and is subject to Singapore tax. Many investors engaged in third country trading have therefore, as a legal tax-avoidance measure, set up establishments in countries which offer tax exemp-

1. See Lee Fook Hong, "Tax Incentives for Economic Development" in "*Taxation in the Asian Countries,*" 2nd Revised Edition, Editor Hamed Talib, APTIRC, Singapore, 1986.

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tion on income derived from such activities. As a result, the financial institutions in Singapore have failed to secure the bulk of the regional trade-related business.

One possible solution to correct this adverse situation faced by the financial institutions in Singapore would be for the Government to grant tax exemption on income derived from third country trading.

E. Lack of tax incentives for upgrading of manpower

Owing to the high pace of development, the banking and finance sectors in Singapore now face a shortage of highly-skilled personnel, particularly in activities related to fund management and reinsurance.

Although there are various schemes for upgrading skills of craftsmen, there seems to be a lack of tax incentives for manpower development and training for the management level especially in the financial sector. Since highly-skilled personnel are essential for the development of this sector, tax incentives such as double deduction for training expenses should be more liberally introduced. Key expatriate personnel and experts should be attracted to work here by granting them tax concessions. In the long run, these expatriates can impart their knowledge and skills to local personnel.

F. Other tax disincentives

Other tax disincentives which inhibit the growth of the banking and finance sector include:

- Uncertainty with regard to the application of certain tax laws, such as those relating to leasing, investment holding and investment trading companies.
- Non-deductibility of expenses incurred in connection with capital raising and venture capital.
- Limited relief for life insurance premiums.

MAJOR AGENCIES AND KEY FACTORS FOR SINGAPORE'S DEVELOPMENT AS FINANCIAL CENTRE

The introduction of tax incentives alone is not sufficient to spur Singapore's financial sector to soar to greater heights. Equally important, if not more, to the bankers/investors would be a well-balanced and favourable business environment.

As a financial centre, Singapore already has certain advantages, namely, political stability, strategic location, excellent infrastructure and well educated workforce. On the other hand, the small domestic market, high cost of doing business and a controlled regulatory environment are some of the negative factors. However, it is encouraging to note that the Government is now taking steps to expand the local capital market with a wider range of instruments and to forge a stronger link with other financial centres such as Japan.

Cost-cutting measures have also been taken, such as reduction of employers' statutory contribution towards the Central Provident Fund by 15 percentage points, from 25% to 10% of wage cost. Some investors feel that a controlled regulatory environment stifles business initiative and discourages businessmen from taking business or finance risks. Perhaps some deregulation, especially to permit a wider range of activities to be carried out by financial institutions, would attract more foreign institutions to set up their base in Singapore and increase the level of financial activities.

To promote Singapore as an international financial centre, Singapore has also taken other non-tax measures. Below are some of the major agencies and key factors for Singapore to develop into an international financial centre:

1. Singapore become a member of the World Bank in 1966.
2. Singapore joined the Asian Development Bank in 1966.
3. The Development Bank of Singapore (DBS Bank) has been set up to provide a wide range of financial services to promote Singapore's industrialization and general economic development.
4. Most banks have computerized their operations either in part or wholly to be in line with the Government's policy to promote automation and higher productivity and to reduce manpower.
5. Merchant banks have been set up to provide services ranging from financial and advisory services; domestic and offshore loan syndication; gold and foreign exchange trading; underwriting of security issues and investment management.
6. Singapore has developed the Foreign Exchange Market as one of the world's most active markets.
7. Insurance companies are encouraged to promote offshore insurance and re-insurance business. Underwriting skills have been upgraded and management expertise has been imported through the efforts of others.
8. Finance companies have been set up to provide deposit-taking services and lending facilities. They help to promote hire-purchase business in the property and motor vehicle sectors.
9. The Stock Exchange of Singapore (SES) has computerized its daily operations. The SES has introduced a computerized data service for investment analysis and decision making to help investors to evaluate the performance of the public-quoted companies.
10. The Securities Industry Council (SIC) has been set up to act as an advisory and consultative body. The SIC's function is to advise the Minister and administer the Securities Industry Act, 1973 (17 of 1973) to protect the investors and prevent unlawful and dishonest trading. The SES is also responsible for enforcing the Singapore Code on Takeovers and Mergers.
11. The Registry of Companies and Businesses is a

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Government Department responsible for administering the Business Registration Act and the Companies Act (Chapter 185).

12. There is no exchange control which has been lifted since 1978. There are no restrictions on remittance or repatriation of capital, profits, dividends, royalties, and other income.
13. Singapore is a major telecommunications centre, linked to many parts of the world by satellite communications, telex lines, telegrams and facsimile services.
14. Singapore has formulated new policies and made efforts to establish the right infrastructure to support the introduction of more modern and advanced technology. There are excellent transportation and communication networks. The scope of technological advancement is limitless and if more funds and manpower are allocated to carry out more research, the existing facilities will be further improved and Singapore will become a truly major financial centre not only in this region but internationally.[2]

RECOMMENDATIONS AND CONCLUDING REMARKS

Singapore has the necessary attributes to be the Switzerland of Asia. The outlook of the economy is bright. The high proportion of savings, low inflation rates, well-developed infrastructure, a large pool of professionals and expertise, fully convertible currency backed by strong international reserves, political stability and efficient administration, combined with the appropriate legal and regulatory framework, in addition to the financial incentives will create the necessary environment to become a premier financial centre.

The following may be worthy of consideration to help further develop Singapore as an international financial centre:

1. *Research regulation* – It may be desirable to set up research centres and institutions for research into the "regulations" of the financial sector. Introduction and recommendation for any new regulations should be implemented only after prior consultation with the financial sector and the business community.

2. *Business Consultative Committee* – A Business Consultative Committee should be set up. Such Committee should comprise representatives from the Government, the business community, professional body and the Federation of the Chambers of Commerce and Industry and the National University of Singapore. It should perform a consultative and advisory role to help to review existing rules, regulations and procedures relating to development of the financial services sector.[3]

3. *Risk management* – With the introduction of currency options, interest rate and currency swops, and forward rate agreements, Singapore has achieved greater sophistication and depth. To further stimulate the risk management activities and attract more foreign companies, financial institutions and institutional investors, greater Government support for financial product innovations and introduction of new financial instruments is crucial. To provide a conducive environment for the development of a venture capital market, fiscal incentives in more practical terms should be more readily available.

4. *Fund management* – Fiscal incentives have been introduced to attract foreign funds and expertise, and new strategies planned to improve management. However, certain grey areas in taxation have hindered the growth in this potential area of growth. For example, there should be clearer guidelines for one to distinguish taxable trading profits from non-taxable capital gains to facilitate business planning and to avoid unnecessary and unproductive disputes between the taxpayers and the Revenue.

5. *Capital market* – The successful operation of the foreign exchange and money market transactions should be extended to other areas in the financial sector. The Government is attempting to develop an active fixed-rate securities market. However, special effort should be made to adjust the existing legal and regulatory framework which appears to be too rigid to accommodate and cope with the rapid changes in the capital market.

6. *Wage restraints* – There is a case for selective wage restraints in different sectors and the Government should review the present general wage restraint policy which affects the financial sector. Perhaps some other incentives should be used to compensate the fall in real income.

7. *Unlisted Securities Market (USM)* – This should be promoted by offering more fiscal incentives and other non-fiscal assistance so as to develop local entrepreneurship as recommended by the Economic Committee headed by Brigadier-General Lee Hsien Loong in his Report "Singapore Economy: New Directions" (1986).

8. *The 4Bs of survival* – Business acumen, business environment, business opportunities and business threats. Singapore businessmen have the business acumen to identify business opportunities and threats. But it is essential to have the support of the Government to provide the right directions and a conducive business environment to develop Singapore as a financial centre.[4]

A financial centre must be developed on its own efforts and merits by the business community itself and not merely by implementation of rules and regulations.

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2. See Lee Fook Hong's commentary on Norman Song's paper entitled "Technology – The Next Decade" delivered at the International Congress of the Australian Division of The Institute of Chartered Secretaries and Administrators held in Sydney in May 1982.
3. See Lee Fook Hong on "The Chartered Secretary in Public Practice" delivered at a seminar organized by the Singapore Association of the Institute of Chartered Secretaries and Administrators held on Friday, 11 July 1986.
4. See Lee Fook Hong's speech to the Rotary Club of Queenstown and reported in the Straits Times, Tuesday, 25 March 1986.

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However, the Government should use tax and non-tax measures to influence the business community and promote business expansion and economic growth.[5]

9. *Diversification* – Singapore lacks natural resources, but has valuable human resources of a high-educational level. Diversification will help economic growth and especially in developing Singapore as a financial centre.

Although Brunei ranked among the richest in the world because of its oil-rich economy, bold measures have been taken to diversify the narrow economic base. Brunei too is moving into the direction to develop expeditiously into a financial centre. Singapore cannot afford to lag behind.[6]

10. *Flexibility and adaptability* – Singapore must strive to continue to be a free enterprise economy with flexibility and adaptability to respond to rapid changes from time to time.

11. *Cost of maintenance* – The well-established efficient infrastructure for Singapore's development as a financial centre must be further expanded and the costs of maintaining such infrastructuring must be kept on par with, if not lower than those of the financial centres in London, New York and Japan.

A conducive business environment must be created not just to compete but to compete successfully in the international market. To recover from the trade recession and to further develop Singapore as a business centre and a major financial centre:
(a) costs of running business must be low,
(b) taxes at minimal rates for both individuals and companies,
(c) workers' attitude must be improved, and
(d) regulations relating to business must be liberalized.

12. *Stock Index Futures* – Trading in stock index futures has been introduced in the stock markets in the Asian time zone. In February 1983, the Australian stock index futures market was started by the Sydney Futures Exchange. Hong Kong established the Hang Seng Index Futures Market in May 1986. Osaka is planning to start a market for trading in Japanese stock index in March 1987. Singapore is also planning to start a stock index futures market sometime at the end of 1986.

All the above merit serious consideration and early implementation. Singapore should continue to maintain the high rating as a stable and safe place to do business as carried out by the California-base Business Environment Risk Information (BERI).[7]

To sum up, the financial services sector appears to be consolidating its position at the moment, after experiencing the effects of the recent economic downturn. The Government can again be depended on for its supportive role in Singapore's next surge in becoming a premier financial sector.

The Minister for Finance, Dr. Richard Hu, in concluding his 1986 Budget Statement on 7 March 1986 had given investors much confidence in Singapore when he 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.

The appeal by the Minister to all Singaporeans "to work together for the next phase of Singapore's economic development" is commendable and worthy of strong support. All Singaporeans and all others concerned should accept the challenge and work harder to achieve the desired goals.

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5. See Lee Fook Hong's comment on Miss Linda Seah's "Issues in Personal Income Tax" in "Issues in Public Finance in Singapore" edited by Mukul Asher and Susan Osborne and published by the Singapore University Press under the auspices of the Economic Society of Singapore.
6. Report in the Straits Times, Tuesday, 15 July 1986.
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APPENDIX A

List of Singapore statutes relevant to the financial services sector

Singapore statutes

1. Acts

The Statutes of the Republic of Singapore, Singapore Law Revision Commission, Attorney-General's Chambers Vols. 1-8
The Banking Act, Cap 1982
The Business Registration Act, 36 of 1973
The Central Provident Fund Act, Cap 121
The Companies Act, Cap 185
The Currency Act, Cap 64
The Economic Expansion Incentives (Relief from Income Tax) Act, 1975
The Finance Companies Act, Cap 191
The Futures Trading Act, 1986
The Income Tax Act, Cap 141
The Insurance Act, Cap 193
The Monetary Authority of Singapore Act, Cap 195
The Property Tax Act, Cap 144
The Securities Industry Act, 1986
The Skills Development Levy Act, 30 of 1979
The Stamp Duties Act, Cap 147
The Statistics Act, 46 of 1973

2. Bills

The Companies (Amendment) Bill, 1986

APPENDIX B

List of Government Gazetted income tax concessionary rates regulations

Regulations	Date of Government Gazette notification
The Income Tax (Concessionary Rate of Tax for Asian Currency Unit Income) Regulations	28 April 1979
The Income Tax (Concessionary Rate of Tax for Income from Insuring and Reinsuring Offshore Risks) Regulations, 1980	17 June 1980
The Income Tax (Concessionary Rate of Tax for Asian Currency Unit Income) (Amendment) Regulations, 1981	19 March 1981
The Income Tax (Concessionary Rate of Tax for Income from Gold Bullion, Gold Futures and Financial Futures) Regulations, 1985	17 December 1985
The Income Tax (Income from Syndicated Offshore Credit and Underwriting Facilities) Regulations, 1986	6 February 1986
The Income Tax (Concessionary Rate of Tax for Asian Currency Unit Income) (Amendment) Regulations, 1986	2 April 1986

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JAPAN:

Ongoing Tax Reform I

By Torao Aoki

The current Japanese tax system was enacted shortly after World War II. Now, a quarter century after their introduction, Japan has embarked upon a drastic overhaul of its tax laws. For this purpose the Japanese Government established a Tax Commission which, after a period of intensive study, finished its interim report on 25 April 1986. On 28 October 1986 the Tax Commission submitted a report on basic policies underlying the Tax Reform to the Prime Minister. On 24 December 1986 the Tax Commission and the Tax Committee of the ruling Liberal-Democratic Party decided on the outline of the Tax Reform. The Government is now preparing the pertinent bills for submission to the Diet (Parliament). This article is the first instalment of a comprehensive article on the pending radical Tax Reform in Japan.

Mr. Aoki is currently a full professor of public finance at the Niigata University in Tokyo and a special member of the research staff at the Institute of Fiscal and Monetary Policy of the Ministry of Finance.

He is a law graduate of the Law School of the University of Tokyo and has an M.A. from the University of Southern California.

He has held various positions in the Japanese Ministry of Finance, including that of Director of the International Tax Affairs Division of the Tax Bureau.

He represented the Japanese Government in the Committee on Fiscal Affairs of the OECD and he has attended meetings of the Tax Experts of the United Nations.

He has been a staff member of the International Monetary Fund and an Executive Director with the Inter-American Development Bank.

I. BACKGROUND

The present tax system of Japan was adopted in 1950 on the basis of the recommendations of the mission headed by Professor Carl S. Shoup of Columbia University during the occupation period after the war. Since then the Japanese tax system has survived spectacular economic and social changes.[1] But now is the time to carefully review and drastically reform the existing tax regime. The Tax Commission created in 1956 as an advisory organ to the Prime Minister has a major role to play in this context. The Commission reviews and recommends the formulation of long-range policy on the structure of the taxes as well as the year-to-year changes. The Tax Committee of the ruling Liberal-Democratic Party also makes recommendations on tax legislation which are usually consistent with those of the Tax Commission of the Government.

In his policy speech at the 102nd Diet session in January 1985, Prime Minister Yasuhiro Nakasone stated that in view of various problems of the tax system due to the social and economic changes an overall reform of the tax system on a broad basis would be required as a task for some time to come. The then Finance Minister Noboru Takeshita also emphasized, in his Budget speech, that the tax system as a whole should be discussed and reviewed from a broad point of view. Lively debates on the reconstruction of Government finances and tax amendment took place at the Diet. Businesses are also increasingly interested in tax reform. Thus, momentum is building toward a tax reform.

1. See Torao Aoki, "A Survey of the Japanese Tax System", 39 *Bulletin for International Fiscal Documentation* 435-445 (1985) and Torao Aoki, "National Taxation System", in Tokue Shibata, ed., *Public Finance in Japan* 103-122, University of Tokyo Press (1986).

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II. REVIEW BY THE TAX COMMISSION

In September 1985, Premier Nakasone requested the Tax Commission to make an overall review of the present tax system. Bearing in mind the recent changes in the social and economic structure of Japan and the expected future developments, the Commission is charged with deliberating a desirable tax system which may obtain the understanding and cooperation of taxpayers and meet the following criteria: equity, fairness, simplicity, the build-up of vitality in the economic society and respect for taxpayers' choices. As the procedure for doing so, the Commission was asked to make recommendations, first of all, for the alleviation and rationalization of tax burdens and then to explore the way to ensure that there are adequate revenue sources for reduction of individual and corporate income taxes. The reform proposals are expected to be revenue neutral, neither increasing nor decreasing the total tax revenues. It was also pointed out that the current tax system leads to various distortions and sometimes imposes heavy burdens as a result of the recent structural changes in industry and employment, the elevation of the level of income, a more even distribution of income, the aging of the population, and the diversification and increasingly service-oriented form of consumption. Thus the Tax Commission has embarked upon a study aimed at the most drastic reform since 1950. The primary objective of the forthcoming reform is to modify a 35 year-old tax system to better fit the present and future social and economic conditions.

For this purpose, in addition to the 30 regular members of the Tax Commission who come from different walks of life representing a variety of groups that influence tax policy, an additional number of special members have been appointed. Three special committees and an expert subcommittee have also been created.

Special Committee No. 1 is to study the general problems, such as the approaches to the tax reform and its relation to expenditures. Special Committee No. 2 is to study individual income tax and social inhabitant tax. Special Committee No. 3 is to study taxation on corporations and estates and indirect taxes. The expert subcommittee composed of academicians is to study the theoretical aspects in response to requests by the Special Committees.

Table 1
Taxes as a percentage of national income

	Japan	U.S.	U.K.	West Germany	France	Sweden
National and local taxes	25.1	26.6	41.9	31.0	33.5	49.1
Social security tax	11.0	10.0	11.4	22.7	28.7	19.9
Total	36.1	36.6	53.3	53.7	62.2	69.0

Source: Economic Planning Agency, the Government of Japan.
Note: For Japan fiscal year 1986 and for other countries fiscal year 1983.

By the end of 1985, each Special Committee had reviewed the existing taxes, consulting with all the circles concerned. Since the turn of the year, the Commission held a local public hearing in Osaka and Hiroshima in search of views and opinions from various sectors. The expert subcommittee prepared reports on (1) the filing or taxpaying units, (2) employment income deduction, (3) progressivity of income tax, and (4) taxation on corporations. After intensive studies on the basis of the reports of the subcommittee, Special Committees Nos. 2 and 3 released their Interim Reports on 25 April 1986. The following is an outline of both Reports.

III. REDUCTION AND RATIONALIZATION OF TAX BURDENS

In the course of the fast economic growth after the war, the level of income has been improved, the number of salaried workers has increased and distribution of income has been equalized. At the same time, on the expenditure side, the social security programmes have been expanded. On top of this, in view of the aging of the population and restrained growth of the economy in the future, it is all the more important that, convinced of the fairness of their tax liabilities, people pay taxes to meet the costs of society. For this purpose the overriding task is to establish a stable revenue structure, endorsed by the understanding and confidence of the people, free from distortions and the feeling of oppression now characterizing the tax system.

As Table 1 indicates, the tax burden in Japan is considerably lower than in most major countries.

Nevertheless, the Japanese taxpayers feel increasingly frustrated by the pressure of the tax burden especially in connection with their income tax liabilities which are a relatively far larger portion of total taxes than in other countries. According to the estimates of the Japanese Ministry of Finance, at the national and local levels combined, income taxes on individuals and corporations and taxes on alcohol, tobacco, commodities and services account for 62.2% and 19.6%, respectively, of the total tax revenues in fiscal year 1986. The OECD Revenue Statistics shows that the corresponding figures in fiscal year 1983 are: 59.8% and 25.3% for the United States; 46.8% and 36.1% for the United Kingdom; 51.9% and 42.8% for West Germany; and 32.1% and 51.3% for France.

The Japanese problems are rooted in the feelings of the middle income class against their accumulated tax burdens and the alleged inequality among different types of income, especially between salaried workers and other income earners. Therefore, in considering the lightening and streamlining of the burden of individual income taxes, it may be necessary not only to discuss the levels of tax rates and deductions, but also to review in depth the very framework of the tax system.

Taking this into consideration, Special Committee No.

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2 suggests radically reducing and rationalizing the burdens of national income tax and local inhabitant tax by analyzing the following three points:

1. Relaxation of progressivity

The present national income tax of Japan is featured by high progressivity with rates rising from 10.5% to 70% in 15 brackets. When local tax is included, the maximum possible tax rate is 88%. Bracket creep often carries wage earners into higher brackets when they get raises or have their salaries adjusted for inflation.

With a view to significantly alleviating the progressivity and simplifying the entire rate structure, the Interim Report proposes lowering the maximum tax rate from 88% to 60%, making the rates applicable over a wider range of income and reducing the number of brackets. In doing so, we must attempt, to the greatest possible extent, to keep ordinary salaried workers in the same bracket from the start to the end of their working career.

2. Introduction of a special deduction for spouses

Concerning a couple with a single wage earner, due regard should be paid to the contribution by housewives engaged in housekeeping earning no income. In order to mitigate their tax burden, a special deduction may be created in addition to the existing spouse allowances.

3. Elaboration on employment income deduction

Another area of widespread discontent is that the self-employed are allowed to itemize business expenses for deduction from their taxable income while salaried earners are only allowed a standard deduction. The Interim Report proposes that the present employment income deduction be divided into a "standard deduction for income-earning expenses" and the "special deduction for adjustment of tax burdens with other income" and that the salaried workers be allowed to choose to itemize the expenses actually incurred for deduction from their taxable income by filing a tax return.

IV. PROBLEMS OF THE PERCEPTION OF HEAVY TAX BURDENS

1. Rate structure

As stated at the outset, in spite of the fairly low level of individual income taxes in Japan by international standards, the middle-income salaried workers complain of heavy tax burdens.

The current rate structure is based on the *Report on the Long-term Tax System of 1965*, stating that the burden should be gradually and smoothly raised as the marginal ability to pay increases from the minimum to the maximum tax rate brackets. Previously, the tax rates were graduated from 10% to 75% and each bracket increased the rate by 5%.

Since the abovementioned Report, the rate structure has been made steeper. Currently, at the lower and middle income brackets the rate increases by only 2%, 3% and 4%, and at the high income bracket by 5%.

As for the patterns of earnings and outlays of the salaried workers who are by far the largest group of income taxpayers, while their income grows until they reach middle age after taking a job, their expenses also increase, e.g. as a result of marriage, childbirth, education and acquisition of a house. To make the matter worse, their tax burdens sharply rise because of the progressive rate structure. With the pressure on family budget mounting, the salary earners tend to complain about heavy taxes.

As mentioned earlier, the greater part of taxpayers concentrate in a certain range of income because of even income distribution in recent years. Furthermore, taking into account the reinforced social security system, the function of individual income tax to redistribute income is relatively weaker than before.

Thus, the time has come to re-evaluate the steep progressivity. Generally speaking, it is pointed out that the excessively high marginal rates and sharp progressiveness would discourage the desire to work and to take entrepreneurial risks and would be detrimental to tax compliance. Furthermore, in these days of increased international mobility of persons and enterprises it might in extreme cases even be possible that capital, income and human resources would shy away from the country.

2. Others

Some argue for reconsideration of the minimum taxable level of income for the purpose of alleviating tax burdens, but others insist on basically reassessing it from the viewpoint that the tax burden should be shared by a broader array of the people who benefit from the higher income level and more even distribution of income. Now that the threshold of income tax of Japan is considerably high, it seems hardly necessary to expand the personal exemptions in general designed for mitigating the burdens of salaried workers.

It is pointed out that the scope of tax-exempt income also should be scrutinized in the interest of equity.

V. PROBLEMS OF INEQUITY AMONG DIFFERENT TYPES OF INCOME

1. Causes for the perception of inequity

It is alleged that the perceptions of inequity and a heavy burden from taxes which salaried workers har-

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bour against other income earners are partly caused by the problems of tax administration such as anomalies in the computation of income and assessment of expenses. It goes without saying that these anomalies should be removed so that the climate for tax compliance may be improved with due regard to the functions of the blue return system under which qualified taxpayers keeping proper financial records are entitled to certain tax privileges.

However, one of the causes for the perception of inequity that should not be overlooked is that salaried workers can neither take advantage of splitting income between a husband and wife, which is available to self-employed taxpayers, nor have any opportunity to file a tax return in which self-employed taxpayers can deduct necessary expenses actually incurred.

2. Income-splitting system

Since business income earners, as a practicality, split their income by virtue of salary payments to their family employees, it is suggested to allow salaried workers to apply the tax rate to half the taxable income and multiply the result by two.

This income-splitting feature is also supported as a means to appreciate the contribution of the spouse to earnings and to solve the problem of part-time workers whose exemption for their spouses is denied if the former's income exceeds a certain amount.

However, caution should be exercised against the adoption of an income-splitting device which drastically changes the filing unit. The reasons are that the tax burden widely would differ depending on the structure of a family and that the two-earner couples will be penalized, thereby discouraging women from taking employment. It is difficult to deny the currently allowed deduction of salary payments to the spouse of the taxpayer filing a blue return for taxation purposes so long as such spouse is actually engaged in a business activity. Should such payments be found excessive, they would be strictly dealt with under the general system.

At the same time, it deserves serious consideration to adjust the tax burden of the single-earner couples in connection with the income-splitting which self-employed taxpayers can avail themselves of by means of payment of salaries to family employees.

It is natural and logical to recognize that in the single-earner couple the housekeeping supports the income-earning activity of the spouse even if the party performing the housekeeping chores is not directly engaged in an income-earning activity. To this extent, it may be appropriate to give some consideration to such spouses for income tax purposes.

However, it is inappropriate to let such spouses split the income since, unlike the family employees of self-employed taxpayers under the blue return regime, the spouses are not directly engaged in income-earning activities. Therefore, one suggested solution may be to create a special allowance in addition to the existing exemption for the spouse in order to reduce the tax burden of the one-earner family, in recognition of the role of the spouse engaged in housekeeping. The rationale is that housewives who limit themselves to their household tasks are not earning wages nor do they generally receive other income but they do assist their husbands in enabling them to work for wages. In that sense housewives contribute to family income and this justifies a certain deduction from taxable family income.

3. Deduction of expenses for salaried workers

At present, salaried workers can deduct 5 to 40% of the amount of their salaries in computing their taxable income depending on the amount of such salaries. Although the levels of this employment income deduction are sufficiently high, on the average amounting to 30% of the salary, discontent and feeling of inequity are very acute among salary earners. It is because the nature of the employment income deduction is not necessarily clear and the expenses actually incurred cannot be itemized for deduction from the taxable income. Usually, taxpayers do not have the opportunity to file a tax return or to calculate their own tax base and tax amount.

From the discussions of the Tax Commission and cases in court, it may be gathered that the current employment income deduction is intended as a rough estimate of the expenses for employment work and, besides, to adjust the tax burden between the salary income with its many peculiar characteristics, and other kinds of income. Therefore, in order to clarify the nature of the employment income deduction and make taxpayers aware of the level of such deduction, it may be advisable to divide the existing employment income deduction into the "deduction of expenses for employment work" and the "special deduction to adjust the tax burdens with other types of income". The salary earners may be given access to filing a tax return for deduction of expenditures for employment work.

Some critics say that introduction of such a deduction of actual expenses runs counter to the simplification of the tax system and that few will choose to itemize deductible expenses in view of the high level of the employment income deduction. Nevertheless, this is considered an inevitable cost for maintaining the confidence in equity and represents a significant step forward in providing alternatives for taxpayers.

Incidentally, for the purpose of opting for itemized deduction of actual expenses, the criteria for such expenses should be specific and clear to the greatest possible extent so that filing of correct returns and tax payments may be achieved. It will take both taxation authorities and taxpayers' time and patience to establish this regime as part of a fairer tax system.

The institutional aspects of the problems of inequity among the various types of income, in addition to the administrative ones mentioned earlier, are the balance

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among different types of earnings and conduct of business, e.g. self-employed taxpayers filing a blue return and those who do not, self-employed who have elected to be regarded as a corporation for tax purposes and those who have not.

VI. CORPORATION TAX

The Interim Report of Special Committee No. 3 treats the subject of taxation of corporations. Its outline is as follows:

1. Level of tax burden of corporations

In Japan, the corporation tax rates have been gradually raised and a variety of measures to increase revenue from corporation tax have been put into effect since the mid-1970s under the stringent circumstances of the Government finances. The "effective tax rate" on corporations, which was on the 40% mark from the late 1950s to early 1970s, now is over 50%. There is no denying that, in terms of the effective tax rate, the burden on corporations in Japan is heavy as compared with that of other industrialized nations. Tentatively, the effective tax rates are estimated by the Japanese Finance Ministry at 52.92% for Japan as against 51.18% for the United States, 40% for the United Kingdom, 56.52% for West Germany and 46.5% for France.

So far enterprises have been active as evidenced by the level of equipment investment and corporate income as a percentage of national income. From now on, however, it should be borne in mind that as the internationalization of the economy advances, the differences in tax burden among the major nations would distort the form of business transactions and exert influence on the investment behaviours of firms.

Under the circumstances, taking into consideration that in Japan the tax on corporations holds far greater implications in the whole tax system than in other advanced countries, and noting that the corporate tax rates are generally on the decline in the world, the level of tax on corporations for years to come should be carefully studied. Partly depending on public finances and the possibility of recurring financial resources, it may be appropriate to lower the effective tax rate from the current 53% to below 50% in the medium term.

2. Tax base

In connection with the level of corporate tax rates, the special tax measures, tax-free reserves and other factors in the tax base should be re-examined from the standpoint of equity in tax burden and the neutrality of tax to the economy.

It is also necessary to re-evaluate if the special tax incentive measures would serve the intended policy purposes in the ever-changing social and economic conditions.

In the absence of a full-fledged revision of the useful life of depreciable assets for a fairly long period, a survey should be conducted to find out the current situation and its implications at the earliest possible opportunity. The methods of depreciation as a whole also should be reviewed from various angles.

3. Mechanism for adjustment of the corporate and individual income tax burdens

The current basic mechanism for adjustment of the burden of corporate and individual income taxes is a combination of the dividends credit at the level of individuals, established since the recommendations of the Shoup mission, with the split-rate corporation tax at the level of the corporation, introduced by the 1967 tax amendment.

After a quarter century of experience, the mechanism for elimination of double taxation on dividend-receiving shareholders and dividend-paying corporations may be reviewed in the context of the stable growth and internationalization faced by the Japanese economy, closely following the trends toward the integration of both taxes in many foreign countries.

To this end, giving due consideration to neutrality in the raising of funds and other economic activities, effects on the international capital movements and stability of the institutions and tax revenues, the present approaches to adjustment at both corporation and individual stages may be subject to further review. This will include a review from the standpoint of simplification of the mechanism for adjustment of such double taxation.

VII. INDIRECT TAXES

On 18 July 1986 the expert subcommittee of the Tax Commission unveiled a report on the possible introduction of new indirect taxes for financing the proposed income and corporation tax reductions which later, on 27 September 1986, were revealed to amount to 2,700 billion yen and 1,800 billion yen, respectively. The report outlining three types of indirect taxes was presented to Special Committee No. 3 of the Tax Commission.

Earlier, on 6 July, the Parliamentary elections were held. In that election campaign, Premier Yasuhiro Nakasone pledged that his Government would not introduce a large-scale indirect tax opposed by the people and ruling party members. It may be remembered that in its report of October 1977 on medium-range tax policy, the Tax Commission proposed a "new tax on consumption on a broad tax base".

In December of the following year a draft outline of the general consumption tax, which was a kind of value added tax, was published. But the proposed new tax was found politically unfeasible.

As present, only liquor, tobacco and a limited number of selected items are subject to indirect taxation in

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Japan. Before the war, from 1934 to 1936, revenues from indirect taxes accounted for 65.2% of the total national tax revenues. After the war the share of such indirect taxes steadily declined from 45.7% in fiscal year 1960 to 33.9% in fiscal year 1970 and to 26.2% in fiscal year 1986. Obviously the current taxation on the selected commodities has several shortcomings.

Recently, people's consumption has been so diversified that it is difficult to choose the items to be taxed. There is a glaring imbalance between the taxed and untaxed items. These days total service expenditure accounts for about half of all personal consumption, but only a small portion of such expenditure is taxed. While the indirect tax revenue, both national and local, as a percentage of the personal consumption expenditure is 7.3% in Japan for fiscal year 1986, the corresponding figures for the United Kingdom, West Germany and France are 19.4%, 18.1% and 20.2%, respectively , in 1984. Furthermore, in Japan, the revenue from tax on services accounts for only 4.9% of the total indirect tax revenues in fiscal year 1985. Foreign countries object to the method of taxing specific items for trade functions.

Radical changes in indirect taxes are considered necessary to eliminate the shortcomings. In view of the lopsidedness between direct and indirect taxes in the total tax revenues an increase in the latter is expected to be a potentially reliable source of badly needed funds to compensate for cuts in direct taxes. What is sought is to institute a system of light, broadly based taxes on all goods and services.

The expert subcommittee took into account the following factors: the new system should conform with Japanese business practices; the payment and collection procedures should be as simple as possible; the new tax should avoid cumulative taxation and uphold equity and neutrality in the economy; and the new programme of indirect taxation should contribute to the reform of the system as a whole.

The new tax could be:
(1) a tax on sales by manufacturers;
(2) a tax on all business sales except on inter-firm transactions; or
(3) a Japanese-style value added tax.

The first of these proposed new taxes would be imposed on all goods at the stage of manufacture with the exception of few items, such as food products. At present, Canada has a manufacturers' sales tax and the expert subcommittee has in effect proposed two possible options.

One is with a list of raw materials, machinery and other goods which are exempt from the tax because they are used in manufacturing processes; and the other is without such a list of tax-exempt goods. In that sense the subcommittee proposes four options instead of three. It may be necessary to employ additional taxes on services which are not subject to the manufacturers' sales tax. Under the second of the proposed taxes, products and services would be taxed when they reach consumers or small-scale enterprises. Transactions between manufacturers, wholesalers and retailers would be exempt from taxation by using tax exemption slips. The Japanese-style value added tax would be imposed on value added at each of the manufacturing, wholesale and retail levels. The tax amount is the difference between the tax computed on these sales and the one on materials consumed in the manufacturing process. Unlike the EC-type value added tax, the proposed one does not use vouchers at every stage of transactions. The last two proposed new taxes cover both goods and services but social security and food products are not subject to either of them.

(To be continued)

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INDIA–CANADA TREATY FOR THE AVOIDANCE OF DOUBLE TAXATION

By Surendra N. Bhargava

Canada and India concluded on 16 September 1986 an agreement on the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income, on the pattern of the U.N. model, which is generally more favourable to developing countries.

The agreement will come into force in India for any assessment year commencing on or after 1 April 1987, and in the case of Canada for taxation years beginning on or after 1 January 1987. In respect of shipping profits, the provisions shall have effect for taxation years commencing on these dates in 1980. For the applicability of the agreement, "Canada" and "India" include their maritime zones.

Shipping and airlines' profits from "international traffic" shall be taxable in the State of residence. Gains from the alienation of ships or aircraft and other movable property used in international traffic shall also be taxed in the State of residence. Other gains may be taxed in both States. Business profits would be exempt in the source State unless the enterprise carries on business in the other State through a "permanent establishment" (PE) situated in that State. The profits attributable to sales of goods and merchandise of the same or similar kind as those sold, or other business activities of the same or similar kind as those effected, through that PE would be taxable in the source State. In determining the profits of a PE, expenses incurred for the purposes of the business shall be allowed including executive and general administrative expenses, whether incurred in the source State or elsewhere. However, the expenses will be subject to limitations prescribed by the taxation laws of the source State. (In India, the "head office expenditure" in the case of non-residents is restricted to 5% of the adjusted total income; amount of average head office expenditure; or head office expenditure attributable to the business and profession in India, whichever is least.) Expenses by way of royalties, fees, commission and interest and other charges in return for the use of patents, know-how or other rights, specific services performed or for management or on money lent to the PE paid or charged shall not be allowed except if it is for reimbursement of actual expenses.

In addition to the usual criteria, a PE exists on account of a warehouse, a sales outlet or premises used for receiving or soliciting orders. A building site or construction or assembly project or related supervisory activities would make a PE if it lasts for a period of more than 3 months (compared to 12 months under the OECD model). Activities in connection with the exploration or exploitation of the sea-bed and subsoil and their natural resources shall be deemed a PE, if these activities are carried out for a period exceeding 30 days in the aggregate in any 12-month period.

Mr. S.N. Bhargava is from the Indian Revenue Service, and is currently Director in the Ministry of Science & Technology, Government of India. He has an M.Sc. in Fiscal Studies from the University of Bath (U.K.). The opinions expressed in the article are the author's own.

Dividends, interest, royalties and technical service fees may be taxed in both the States. However, the tax in the source State shall be limited to a specified percentage of the gross payments. Dividends – 15% in the case of a recipient company having 10% of the portfolio investment and 25% in the other cases. The concessional rate in India shall apply only if that dividend is not taxed in Canada. This limitation applies only to dividends paid out of profits from investment made after the date of signature of the agreement. Interest – 15% if the recipient is a beneficial owner; exempt if the payer is the central or provincial Government or local authority of the source State or in the case of specified payees. Royalties and technical service fees – 30%. The rate will apply in respect of technology transfers under arrangements made or contracts entered into after the date of signature of the agreement. In India, the withholding tax on royalties and technical service fees is 30% in the case of a company and a variable rate in other cases. In Canada the rate, being lower at 25%, may continue to apply.

Employment income is taxable in the State where the employment is so exercised. This is subject to the exception if the employee is present in the source State for a period not exceeding in the aggregate 183 days in the concerned fiscal year and some other routine conditions. Professional services shall be taxable in the source State except if the recipient stays in the source State for a period exceeding 183 days in the aggregate and some other routine conditions.

The elimination of double taxation shall be by credit method. For this purpose tax spared in India under specified incentive provisions shall also be taken into account. However, the latter benefit shall be available only for the first 10 fiscal years from the first year of relief.

India is emerging as an important market for Canada. Canada's exports to India in 1985 were Can.$ 489 m. and imports were Can.$ 168 m. The total trade between the two countries had increased from $ 67 m. in 1960 to $ 650 m. in 1984. As a first step, showing considerable interest in India, the Canadian Government had opened a trade office in Bombay and formed a business cooperative register for the Western region to provide a point of contact. Indian businessmen could expand the market for their goods exported to the U.S.A. by exporting them to Canada also. The Canadian private sector seems to be impressed with the new economic direction in India. Both countries could benefit by private and mixed participation in-

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cluding joint ventures in Latin America and Africa. Canada could also transfer technology to India by licensing limited rights to the technology, normally for a fixed period of time. In 1985, 18 Indo–Canadian colloborations were approved, mostly technical in nature. It is hoped that with the coming into force of this agreement, the physical distance and unawareness about each other's capabilities and potentials will not come in the way of Indo–Canadian economic cooperation. Due to the lower rate of tax on dividends, interest and technical fees under the treaty, there will be a boost to joint colloborations.

INTERNATIONAL BAR ASSOCIATION

Section on Business Law

News from its Tax Committee N (Taxes)

The 1986 IBA Conference New York – 15 to 19 September 1986

The Committee organised four full day working sessions. In response to the increasing numbers attending the sessions and at the request of the members the Committee for the first time successfully offered two parallel sessions on the same day. It is intended to repeat this at future conferences.

A full report on the proceedings of the Committee will appear in the January edition of the International Bar News.

The 1987 IBA Section on Business Law Conference London – 14 to 18 September 1987

The working programme will be:

I. National tax developments international tax lawyers need to know

A review of the most important recent tax development in selected countries. This ever popular session is a must for international tax lawyers. The benefit of full participation by members is recognised; opportunity is provided for questions and discussion is encouraged.

II. Taxes and high tech operations

This topic which was commenced at the New York conference will continue with an update on the issues discussed in New York.

Taxes and international venture capital operations

Tax practitioners will frequently be asked to advise in connection with the raising of venture capital. This session examines the principal tax considerations relevant to venture capital.

III. The issue of international securities

The morning session will be a joint session with Committee Q (Issues and Trading in Securities) and will examine those tax factors which influence both the structure and the terms and conditions of such an issue of securities. The integration of the tax and securities law aspects of such an issue will be illustrated.

The issue of international securities: taxation considerations

The session will continue with an indepth study of the tax factors arising in connection with an issue of securities in selected countries.

London is the world-wide centre of the eurobond markets and this topic is specifically selected for the London conference.

IV. Mutual assistance in tax matters – Recent developments in bilateral and multilateral relations

A proper understanding of the extent of co-operation between fiscal authorities in assisting a particular fiscal authority to identify and collect tax properly due to that authority is of critical importance to tax practitioners. This session will examine recent developments in both bilateral and multilateral treaties including the draft OECD Convention on mutual administrative assistance in tax matters. Representatives of an appropriate fiscal authority or relevant international organisation may participate.

Sessions III and IV will be offered as parallel sessions on the same day.

The 1988 IBA Conference Buenos Aires – 25 to 30 September 1988

A tentative working programme has been agreed which will be:

(1) National tax developments which international tax lawyers need to know;
(2) A topic specifically related to South America. This will be selected at the London conference by reference to then current developments in South America; and
(3) The taxation of joint ventures.

Participation of members

The officers of the committee encourage active involvement in the affairs of the committee by all members.

The officers are grateful to those members who attended the business meeting of the committee in New York and who contributed by offering so many helpful suggestions in connection with the working sessions of the committee. Any comments and suggestions at any time in relation to the work of the committee are welcomed by the officers.

Members are encouraged to invite other tax lawyers with whom they are in contact from time to time to join the committee.

The papers prepared by the committee including this press release and the Chairman's report may be published by members either in publications produced by their firms or other publications generally read by tax practitioners. Members are encouraged to seek out and exploit such opportunities.

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TAXES:

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TAX TREATMENT OF CERTAIN PERSONS AND TRANSACTIONS:

Establishment and expansion of business / Taxes on transfer of shares, bonds and other securities / Liquidation, amalgamation and mergers / Investment income (dividends, interest, royalties, etc.) / Group taxation / Permanent establishment / Directors and shareholders

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Twists and Turns in the Tax Rules for Foreign Companies Owning Real Estate in France

By Christian Laroche

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I. INTRODUCTION

As a consequence of the 16 March 1986 general elections and the new Government, the Finance Amendment Act 1986 (No. 86-824 of 11 July 1986) eliminated the wealth tax created by the former left majority in 1981 (to begin in the fiscal year 1 January 1987). Therefore it would be consistent if further legislation would propose the reduction of 3% tax created by the Finance Act 1983 if not the deletion of it.

The 3% tax rate may be considered equivalent to the wealth tax imposed on the individual shareholders of foreign companies since those individuals could not be assessed for wealth tax when their existence was unknown to the French tax authorities (see III.A. below).

The situation with respect to foreign companies owning real estate in France seems now to have been stabilized after undergoing many unpleasant twists and turns since 1977.

The regulation presently in force is a compilation of several successive legislative enactments for which the following study is intended to present the development more clearly.

Let us then recall the situation which existed before 1 January 1983 (II) and then examine the prospects resulting from the Finance Act for 1983 (III).

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The elimination of double taxation shall be by credit method. For this purpose tax spared in India under specified incentive provisions shall also be taken into account. However, the latter benefit shall be available only for the first 10 fiscal years from the first year of relief.

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Mr. S.N. Bhargava is from the Indian Revenue Service, and is currently Director in the Ministry of Science & Technology, Government of India. He has an M.Sc. in Fiscal Studies from the University of Bath (U.K.). The opinions expressed in the article are the author's own.

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cluding joint ventures in Latin America and Africa. Canada could also transfer technology to India by licensing limited rights to the technology, normally for a fixed period of time. In 1985, 18 Indo–Canadian colloborations were approved, mostly technical in nature. It is hoped that with the coming into force of this agreement, the physical distance and unawareness about each other's capabilities and potentials will not come in the way of Indo–Canadian economic cooperation. Due to the lower rate of tax on dividends, interest and technical fees under the treaty, there will be a boost to joint colloborations.

INTERNATIONAL BAR ASSOCIATION

Section on Business Law

News from its Tax Committee N (Taxes)

The 1986 IBA Conference New York – 15 to 19 September 1986

The Committee organised four full day working sessions. In response to the increasing numbers attending the sessions and at the request of the members the Committee for the first time successfully offered two parallel sessions on the same day. It is intended to repeat this at future conferences.

A full report on the proceedings of the Committee will appear in the January edition of the International Bar News.

The 1987 IBA Section on Business Law Conference London – 14 to 18 September 1987

The working programme will be:

I. National tax developments international tax lawyers need to know

A review of the most important recent tax development in selected countries. This ever popular session is a must for international tax lawyers. The benefit of full participation by members is recognised; opportunity is provided for questions and discussion is encouraged.

II. Taxes and high tech operations

This topic which was commenced at the New York conference will continue with an update on the issues discussed in New York.

Taxes and international venture capital operations

Tax practitioners will frequently be asked to advise in connection with the raising of venture capital. This session examines the principal tax considerations relevant to venture capital.

III. The issue of international securities

The morning session will be a joint session with Committee Q (Issues and Trading in Securities) and will examine those tax factors which influence both the structure and the terms and conditions of such an issue of securities. The integration of the tax and securities law aspects of such an issue will be illustrated.

The issue of international securities: taxation considerations

The session will continue with an indepth study of the tax factors arising in connection with an issue of securities in selected countries.

London is the world-wide centre of the eurobond markets and this topic is specifically selected for the London conference.

IV. Mutual assistance in tax matters – Recent developments in bilateral and multilateral relations

A proper understanding of the extent of co-operation between fiscal authorities in assisting a particular fiscal authority to identify and collect tax properly due to that authority is of critical importance to tax practitioners. This session will examine recent developments in both bilateral and multilateral treaties including the draft OECD Convention on mutual administrative assistance in tax matters. Representatives of an appropriate fiscal authority or relevant international organisation may participate.

Sessions III and IV will be offered as parallel sessions on the same day.

The 1988 IBA Conference Buenos Aires – 25 to 30 September 1988

A tentative working programme has been agreed which will be:

(1) National tax developments which international tax lawyers need to know;
(2) A topic specifically related to South America. This will be selected at the London conference by reference to then current developments in South America; and
(3) The taxation of joint ventures.

Participation of members

The officers of the committee encourage active involvement in the affairs of the committee by all members.

The officers are grateful to those members who attended the business meeting of the committee in New York and who contributed by offering so many helpful suggestions in connection with the working sessions of the committee. Any comments and suggestions at any time in relation to the work of the committee are welcomed by the officers.

Members are encouraged to invite other tax lawyers with whom they are in contact from time to time to join the committee.

The papers prepared by the committee including this press release and the Chairman's report may be published by members either in publications produced by their firms or other publications generally read by tax practitioners. Members are encouraged to seek out and exploit such opportunities.

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TAX TREATMENT OF CERTAIN PERSONS AND TRANSACTIONS:

Establishment and expansion of business / Taxes on transfer of shares, bonds and other securities / Liquidation, amalgamation and mergers / Investment income (dividends, interest, royalties, etc.) / Group taxation / Permanent establishment / Directors and shareholders

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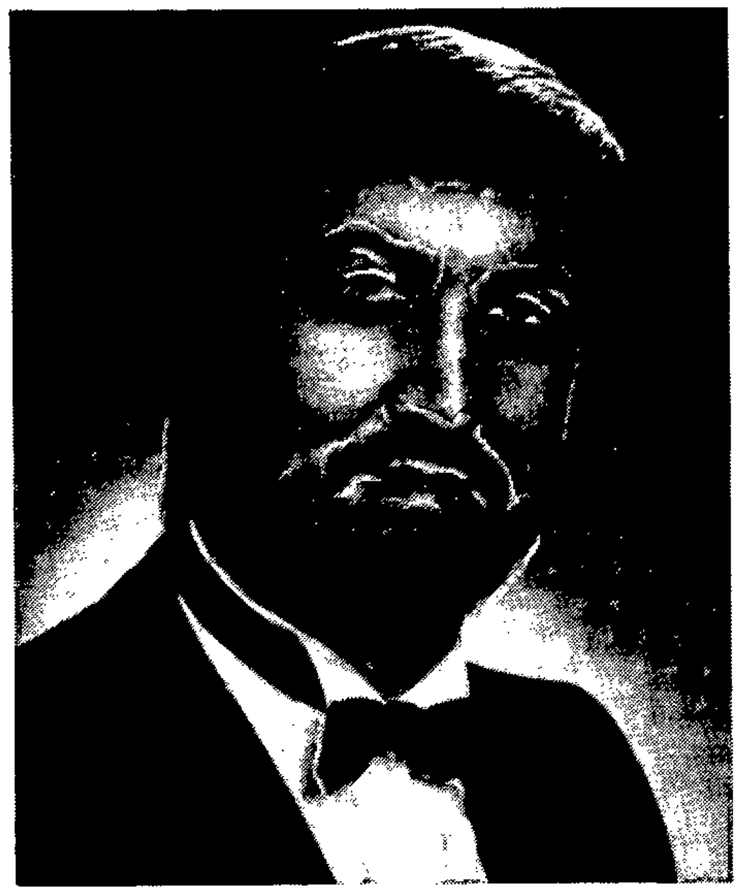
Twists and Turns in the Tax Rules for Foreign Companies Owning Real Estate in France



By Christian Laroche

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I. INTRODUCTION

As a consequence of the 16 March 1986 general elections and the new Government, the Finance Amendment Act 1986 (No. 86-824 of 11 July 1986) eliminated the wealth tax created by the former left majority in 1981 (to begin in the fiscal year 1 January 1987). Therefore it would be consistent if further legislation would propose the reduction of 3% tax created by the Finance Act 1983 if not the deletion of it.

The 3% tax rate may be considered equivalent to the wealth tax imposed on the individual shareholders of foreign companies since those individuals could not be assessed for wealth tax when their existence was unknown to the French tax authorities (see III.A. below).

The situation with respect to foreign companies owning real estate in France seems now to have been stabilized after undergoing many unpleasant twists and turns since 1977.

The regulation presently in force is a compilation of several successive legislative enactments for which the following study is intended to present the development more clearly.

Let us then recall the situation which existed before 1 January 1983 (II) and then examine the prospects resulting from the Finance Act for 1983 (III).

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rule was that, to compute the taxable base for purposes of the substitute withholding tax, one had to deduct from the income subject to corporate income tax, the corporate income tax itself and any of the 33⅓% prélèvement due.[32] However, this rule did *not* apply in the case discussed here, since the taxable base could *not* be lower than the value of the benefit in kind which represented the distribution made during the year in question.

Example 3 illustrates the situation as described by the tax authorities.

C. The presumption of ownership under the provisions of the new wealth tax

To prevent taxpayers from hiding the ownership of real property situated in France or abroad through the use of real property holding companies established in tax haven countries, the Finance Law for 1982, Art. 5(IV) introduced a "presumptive ownership" for purposes of French wealth tax. Under this provision, any individual person who enjoyed the use of real property owned by a company would be presumed the owner of that property if established in a country with which France had not concluded a treaty providing administrative assistance to combat tax evasion and tax fraud unless he could substantiate that the company was effectively controlled by a third party. The presumptive ownership was therefore assumed if the following three conditions were met:

- an individual person enjoyed the use of the property; and
- the property belonged to a legal entity established in a country with which France had not concluded a treaty to combat tax evasion and tax fraud; and
- the individual person who enjoyed the use of the property did not prove that the entity in question was not controlled by him, but by other persons.

This new provision was rarely applied since the taxation of real property was completely changed by the introduction of the Finance Law for 1983.

28. It appeared that many tax inspectors who had received tax returns indicating the income from the renting of French real property, had imposed the substitute withholding tax, taking into account the reduced taxation provided for in a number of tax treaties (for instance the tax treaties with the Netherlands and Switzerland). In a large number of cases, therefore, taxpayers had to file complaints in order to get a refund of the substitute withholding tax incorrectly levied.
29. "Provisional", because if the non-resident legal entity could show that part of the dividends it distributed went to shareholders in France or if it could show that the total amount of dividend it distributed was less than the income on which the substitute withholding tax was levied, an adjustment would take place (a very theoretical situation, indeed!).
30. This means that if CGI, Art. 209 A was applied, the substitute withholding tax was levied on an amount equal to one time the real annual rental value. In other words, the taxable base for purposes of the corporate income tax and the substitute withholding tax must be computed in a different manner.
31. See note 10 and accompanying text.
32. See note 23 and accompanying text.
33. The report of the special commission is known as the "Rapport GOUX" (A.N. No. 1046, annex to the minutes of the meeting of 22 July 1982).

III. THE OUTLOOK OFFERED BY THE FINANCE LAW FOR 1983

In the autumn of 1982 there were no indications in the Finance Law for 1983 drafted by the Mauroy Government which would make one suspect that the tax regime for non-resident real property companies would be completely changed. There were rumors that certain foreign persons, who were in a position to make substantial contributions to help to finance the French budget deficit, put pressure on the French Government in order to extract themselves from the trap in which they had walked by using tax haven companies as intermediaries. Thus, the changes which resulted in the present legislation were introduced during the parliamentary procedure.

The new regime, which will be examined below, is conceptually simpler than the old system which was poorly described in the Ruling of 8 February 1982. However, the new system can impose a much heavier tax burden than the old one under certain circumstances.

A. The new taxation introduced by the Finance Law for 1983

The Finance Commission of the Lower House (Assemblée Nationale) gave the following reasoning for the introduction of the new tax provisions:

> A large number of properties situated in France are held through non-resident companies which are mostly established in tax haven countries. This is an unhealthy situation which favours tax evasion. In 1976 legislation was introduced to penalize the use of such constructions in CGI, Art. 209 A, which imposed a minimum corporate income tax. However, the Parliamentary Mission charged with combating the illegal exportation of capital has shown that this article has been ineffectual and even undesirable in those cases where its application could be avoided through a set-up which, paradoxically, permitted the taxpayers to legally export their capital. This report[33] envisaged the deletion of the pertinent legal text.

This is the purpose of the present amendment. However, the use of non-resident companies in the real property field is too widespread and the risks of tax evasion are too great to simply delete CGI, Art. 209 A, without offering a solution for its replacement. This is the reason that it has also been proposed:

- on the one hand, to subject companies which are established in a tax haven country and which own real property in France to an annual wealth tax. For their non-resident participants (shareholders), the tax paid by the companies would, to a certain extent, replace the capital taxes which would normally be due;
- on the other hand, to temporarily favour the removal of the legal shelter which is offered by the non-resident company and to re-establish a situation under which the real owner would hold the property directly;
- finally, to discourage the acquisition of real prop-

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erty by companies established in tax haven countries by increasing the registration tax.[34]

Thus, the following amendments were proposed:

- companies whose registered head office was outside France and which possessed real property in France would be subject to an annual tax of 3% of the market value of such property;
- taxpayers who owned real property in France would be permitted to remove the legal shelter constituted by the non-resident holding company and to revert to direct ownership of the property concerned by paying a 20% lump-sum tax ("exit tax") on the market value of such property on or before 31 December 1983 (this date was eventually changed to 15 May 1984);
- the reduced rate of transfer tax (registration tax) payable at the purchase of dwelling houses would no longer be available to companies established in a tax haven country;
- shares and participations in non-resident real property companies would be considered to be French property and would thus be subjected to French inheritance and gift tax;
- CGI, Art. 902 A and Art. 5(IV) of the Finance Law for 1982 regarding the net wealth tax would be deleted.

The parliamentary debates did not shed much light on the new measures. However, during these debates the rate of "exit tax" was reduced from 20% to 15%.

We will now discuss the most important provisions of the new legislation which have been commented upon by the Administrative Ruling of 13 April 1983 (Official Bulletin of the Tax Administration, No. 7 Q-1-83).

(1) *The annual 3% tax*

As of 1 January 1983, legal entities whose registered head office is situated outside France and which possess French-situs real property are, in principle, subject to an annual tax of 3% on the market value of such property. Apart from a number of exceptions, which are discussed below, the tax is levied on all legal entities having their registered head office outside of France, regardless of their legal form, i.e. they can be corporations, partnerships, etc. However, the following legal entities are exempt:

- legal entities which own French-situs real property representing less than 50% of their French-situs assets (Real property which is used for the entities' *own* industrial, commercial, agricultural or other business purposes is not affected by the new law);
- legal entities who have their registered head office in a country with which France has concluded a treaty for administrative assistance in preventing tax fraud and tax evasion provided that they report each year to the French tax authorities;
  - the location, the description and the value of the property (ies) held on 1 January of the pertinent year;
  - the identity and the addresses of the shareholders or participants; and
  - the number of shares or participations held by them.

  The tax is, therefore, not due if the tax authorities know the names of the shareholders of and participants in the legal entity and can use the administrative assistance provided for in tax treaties to check the accuracy of their information. In Western Europe Switzerland is the only country whose tax treaty with France does not contain an administrative assistance clause;
- international organizations, foreign sovereign States and foreign public institutions;
- pension funds and other non-profit organizations which perform non-remunerative activities of a social, philantropic, educational or cultural nature and which prove that these activities justify the ownership of real property in France.

The tax concerns, in principle, buildings and unimproved land situated in France as well as real property rights, such as usufruct, right of enjoyment, etc. It is immaterial whether the property has been rented to a third party or not. The tax is also due if a non-resident company owns real property or real property rights through a French real property holding company.

The tax is levied at the rate of 3% on the market value of French-situs real property on 1 January of the pertinent year. The French tax authorities define the term "market value" as the price which could or should normally be charged at the sale of such property.

As stated above, a non-resident entity must submit annually (on or before 15 May) a return including the location of the property, its description, and the market value of the French-situs real property or real property rights which it possessed on 1 January of the pertinent year. This return must be submitted either to the Tax Collector of the district where the property is situated or to the Center for Non-Residents in Paris, if a number of local tax collectors are involved. As is the case for the wealth tax, the tax must be paid when making the declaration.

The non-resident legal entity is the person who owes the tax. However, if the property is held through an intermediary person, the latter is severally liable for the payment of the tax. In addition, the fiscal representative which the non-resident taxpayer must appoint when selling real property situated in France for the imposition of the 33⅓% "prélèvement" is responsible for the payment of any tax still due for the year in which the sale took place if he has expressly bound himself.

Note that the tax is not deductible for purposes of the individual income tax or corporate income tax which remains due under the normal rules of French tax law.

34. The acquisition of real property in France is subject to various registration taxes. Their aggregate rates vary from "département" to "départment" from approximately 18% to 19%. A reduced rate (approximately 7%) applies to dwelling houses.

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The French tax authorities may request the non-resident entity which is subject to the 3% annual tax to appoint within 90 days from the receipt of such a request a fiscal representative in France. This person must be authorized to receive the communications from the French tax authorities with respect to the taxable base of the tax, its collection and possible litigation.[35] However, he will *not* be liable for the payment of the tax debts of the entity. It is noted that the representative may submit a return for the entity only if he has received express authorization.

The provisions, regarding the determination of the tax due in case of non-declaration, which are applicable to the net wealth tax also apply to the 3% annual tax. In such a case, the tax authorities may unilaterally determine the tax to be paid provided they have sent the taxpayer a summons and the latter did not respond within 2 months.[36]

Otherwise, the 3% annual tax is collected in conformity with the provisions which exist for registration taxes and the same penalties apply. However, two special provisions which are also applicable to the net wealth tax have been provided for by the Finance Law for 1983, i.e.:

- the rate of the penalty for late payment provided for in CGI, Art. 1727 is increased from 3% to 10% of the tax due for the first month that the taxpayer is late. For the other months the rate remains 1%;
- if the tax authorities were forced to unilaterally determine the amount of tax due (see above) the penalty may not be less than 30% of the tax which was paid late.

Under Art. 4(1)(2) of the Finance Law for 1983, any shares or participations in legal entities having their registered head office abroad whose assets mainly consist of real property or real property rights situated in France, are deemed to be French property and are subject to French net wealth tax, inheritance and gift tax. However, if such an entity has been subject to the 3% annual tax, its *non-resident* shareholders or participants are subject to neither the wealth tax, the inheritance tax nor the gift tax, with respect to the shares or participations which they own. According to the tax authorities, they remain subject to the 33⅓% "prélèvement" in case they sell their shares or participations.[37] On the other hand, the 3% annual tax does not replace the corporate income tax on rents which remain due.[38] These provisions have now been codified as CGI, Arts. 990 A through 990 G.

(2) *The 15% "exit tax"*

In order to favour the removal of the tax shelters of non-resident legal entities, the Finance Law for 1983 introduced a 15% lump-sum tax on the value of French-situs real property owned by non-resident legal entities, which would replace any other taxes normally due at the distribution of such assets to its shareholders or participants. Initially, such favoured tax treatment was available until 31 December 1983, but this date was first changed to 15 May 1984[39] and later to 15 September 1984.[40]

The legal entities concerned where those that fell under the scope of the 3% capital tax, whether they were effectively subject to this tax or exempt. In order to become eligible for the regime of the "exit tax", the non-resident legal entity had to transfer real property which it owned to an individual who was a shareholder or participant in the entity concerned. Such a transfer could not be the result of the sale of the property to one or more shareholders or participants. The transfer had to be effected through either a liquidation of the entity concerned or by a partial distribution of its assets. However, real property acquired after 1 January 1983 did not qualify for such a privileged transfer. The document pertaining to the transfer of the property had to be registered *before* 15 September 1984. The "exit tax" would only become payable after express election by the taxpayer at the moment the document was registered. Of course, where such election was not made, the normal taxes were due.

The 15% "exit tax" was computed on the market value of the property on 1 January 1983. The tax not only became due at the moment of registration, but also had to be paid immediately.

As stated by the tax authorities,[41] the transfer had to be effected without any consideration in cash or in kind paid to the legal entity making the transfer.

This condition was considered to be met if the shareholder or participant waived any debts which the entity owed to these shareholders or participants. However, the situation would be different if those debts were incurred as of the moment that the Finance Law 1983 became effective and were, considering their amount, clearly an advance payment for the property transferred.

Similarly, the regime of the "exit tax" would be refused if after the event the shareholders or participants sold the property soon after it had been transferred to them.

A special case was where a non-resident legal entity (A) would hold a participation of more than 50% in a French real property company (B) which was deemed to be an "intermediary" company, of which the remainder of its shares were held by trust companies (C and D). The question which was raised was whether it would be possible to apply for the 15% "exit tax" when total real property would be transferred to an individual person (X), shareholder of

35. CGI, Art. 223 quinquies A.
36. Livre des Procédures Fiscales, Art. L. 76.
37. CGI, Art. 244 bis A.
38. See II.A.1.a. above.
39. Finance Law 1984, Art. 31 (I)(4).
40. This was effected by a simple administrative measure. The Finance Minister replied in Parliament to Mr. Colonna, M.P., that "when amending the tax regime of real property owned in France by non-resident companies, the legislature wished to allow such companies to be exempt from the 3% tax on the market value which it introduced by transferring the property on or before 15 May 1984. For reasons of efficiency, it was decided that this date would be moved to 15 September 1984". Thus the postponement of the "fatal" date was not even announced through an official announcement, but only through an answer given to a Member of Parliament to a question asked on 9 April 1984 *Official Journal, debates of the Lower House (Assemblée Nationale)*, 7 May 1984 at 2,136).
41. Supplementary Ruling regarding the 15% "exit tax" of 9 February 1984 (Official Bulletin No. 7 Q-1-84).

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the non-resident legal entity (A) although the individual (X) was not a shareholder of either one of the trust companies (C and D). The tax authorities gave as their opinion that under these circumstances legal entity A could only transfer its *shares* in company B to X under the imposition of the 15% "exit tax", these shares being deemed to be real property. With respect to trust companies C and D it was assumed that they had behaved vis-à-vis third parties as if they were the real owners of part of the capital of company B. C and D were non-resident companies, they could also transfer their shares in B under payment of the "exit tax" to X. X would then be the sole shareholder of B and it would be possible to liquidate B and transfer the property to X without any capital gains tax becoming due.

The option for the payment of the 15% "exit tax" had to be made at the bottom of the document which pertains to the transfer of the property. Such option could be phrased as follows: "parties concerned express their wish to opt for the imposition of the 15% tax provided for in CGI, Art. 990 H". The tax became payable immediately at the registration of the document concerned.

In practice, the French notary took care of its payment and also paid the fees for the registration of the document which he charged to his client as well as his own fee which was a function of the market value of the property concerned.

The transfer of real property after the payment of the 15% "exit tax" exempted the taxpayer from the 3% annual tax payable during 1983 and 1984. If the taxpayer had already paid the 3% annual tax in 1983, or in 1983 *and* 1984, he could credit the tax paid against the 15% "exit tax", so that in such a case only 12% or 9% "exit tax" would be due. The 15% "exit tax" exempted the non-resident legal entities and their shareholders or participants receiving the property from any tax connected with such a transaction. The exemption concerned the imposition of registration tax due on the transfer of shares or participations representing real property to the shareholders and participants or the registration tax which was due upon liquidation of the entity followed by the transfer of its assets, and also the "prélèvement" and corporate income tax on the capital gains.[42]

In addition, unless the imposition of tax resulted from a tax audit begun or announced before 19 October 1982 (i.e. the date on which the text of the bill was submitted to the Lower House), the payment of the 15% tax exempted the legal entities concerned as well as their shareholders or participants from any tax penalties which could be imposed with respect to the property transferred during the period preceding 19 October 1982.

This exemption essentially concerned the corporate income tax to which the legal entity could be subjected during the period for which the statute of limitations had not yet expired, either the corporate income tax computed under the "normal" provisions or under CGI, Art. 209 A.[43] It also concerned the substitute withholding tax imposed under CGI, Art. 115 quinquies, and, with respect to individual taxpayers, it concerned the net wealth tax levied on the value of the shares or participations representing the real property transferred.

In other words, the Finance Law for 1983 provided that the imposition of a tax and penalties resulting from tax audits begun on or after 19 October 1982 was waived provided that the non-resident legal entity transferred its real property to one or more of its shareholders or participations before 15 September 1984, and that it paid 15% tax on the market value of such assets.

It is rather surprising that no amnesty at all – not even partial amnesty – was offered with respect to earlier tax audits. The result was that entities which succeeded in escaping notice by the French tax authorities or which resorted to a tax office whose agents were somewhat less zealous, received favoured treatment under the law! It is for this reason that the tax authorities were authorized to remedy this situation to a certain extent by an unpublished ministerial ruling on 22 February 1984 (see B. below).

(3) *Changes of certain transfer taxes*

In order to discourage non-resident legal entities established in tax haven countries from acquiring dwelling houses in France, the reduced 2.6% rate of transfer tax (registration tax) provided for in CGI, Art. 710 was not applicable to non-resident entities established in a country with which France had *not* concluded a treaty containing a mutual assistance clause under which the Contracting States could combat tax fraud and tax evasion. In other words, if such an entity purchased a dwelling house in France, it was, as of 1 January 1983, subject to the various transfer taxes currently totalling 18%-19%.[44] This also applied to garages and land destined for the building which normally benefit from the same rate reduction as dwelling houses.[45]

The provisions of the Finance Law for 1983 also had an impact on the so-called "territoriality" rule regarding French transfer tax (registration taxes), in particular to those imposed at death and in the case of gifts (inheritance and gift taxes) and the French net wealth tax. By virtue of CGI, Art. 750 ter, non-residents are only subject to inheritance tax, gift tax or net wealth tax with respect to movable and immovable property situated in France, including shares and participations issued by French companies which are deemed to be located in France. However, shares and participations which are issued by a non-resident company are normally not considered to be situated in France and are consequently not subject to these taxes. The Finance Law for 1983, Art. 4 added a new category of property situated in France to existing legislation by providing that, henceforth, the shares and participations issued by non-resident companies whose assets consist mainly (i.e. more than 50%) of real property and real property rights situated in France, are also deemed to be situated in France. In order to establish whether a

42. CGI, Art. 244 bis A. See also not 7, 19, 23 and accompanying texts.
43. Note that the provisions of CGI, Art 209 A remained applicable to accounting years closed before 1 January 1982.
44. CGI, Art. 783. See note 34.
45. CGI, Art. 711.

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rule was that, to compute the taxable base for purposes of the substitute withholding tax, one had to deduct from the income subject to corporate income tax, the corporate income tax itself and any of the 33⅓% prélèvement due.[32] However, this rule did *not* apply in the case discussed here, since the taxable base could *not* be lower than the value of the benefit in kind which represented the distribution made during the year in question.

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31. See note 10 and accompanying text.
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33. The report of the special commission is known as the "Rapport GOUX" (A.N. No. 1046, annex to the minutes of the meeting of 22 July 1982).

III. THE OUTLOOK OFFERED BY THE FINANCE LAW FOR 1983

In the autumn of 1982 there were no indications in the Finance Law for 1983 drafted by the Mauroy Government which would make one suspect that the tax regime for non-resident real property companies would be completely changed. There were rumors that certain foreign persons, who were in a position to make substantial contributions to help to finance the French budget deficit, put pressure on the French Government in order to extract themselves from the trap in which they had walked by using tax haven companies as intermediaries. Thus, the changes which resulted in the present legislation were introduced during the parliamentary procedure.

The new regime, which will be examined below, is conceptually simpler than the old system which was poorly described in the Ruling of 8 February 1982. However, the new system can impose a much heavier tax burden than the old one under certain circumstances.

A. The new taxation introduced by the Finance Law for 1983

The Finance Commission of the Lower House (Assemblée Nationale) gave the following reasoning for the introduction of the new tax provisions.

> A large number of properties situated in France are held through non-resident companies which are mostly established in tax haven countries. This is an unhealthy situation which favours tax evasion. In 1976 legislation was introduced to penalize the use of such constructions in CGI, Art. 209 A, which imposed a minimum corporate income tax. However, the Parliamentary Mission charged with combating the illegal exportation of capital has shown that this article has been ineffectual and even undesirable in those cases where its application could be avoided through a set-up which, paradoxically, permitted the taxpayers to legally export their capital. This report[33] envisaged the deletion of the pertinent legal text.
>
> This is the purpose of the present amendment. However, the use of non-resident companies in the real property field is too widespread and the risks of tax evasion are too great to simply delete CGI, Art. 209 A, without offering a solution for its replacement. This is the reason that it has also been proposed:
>
> - on the one hand, to subject companies which are established in a tax haven country and which own real property in France to an annual wealth tax. For their non-resident participants (shareholders), the tax paid by the companies would, to a certain extent, replace the capital taxes which would normally be due;
> - on the other hand, to temporarily favour the removal of the legal shelter which is offered by the non-resident company and to re-establish a situation under which the real owner would hold the property directly;
> - finally, to discourage the acquisition of real prop-

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erty by companies established in tax haven countries by increasing the registration tax.[34]

Thus, the following amendments were proposed:

- companies whose registered head office was outside France and which possessed real property in France would be subject to an annual tax of 3% of the market value of such property;
- taxpayers who owned real property in France would be permitted to remove the legal shelter constituted by the non-resident holding company and to revert to direct ownership of the property concerned by paying a 20% lump-sum tax ("exit tax") on the market value of such property on or before 31 December 1983 (this date was eventually changed to 15 May 1984);
- the reduced rate of transfer tax (registration tax) payable at the purchase of dwelling houses would no longer be available to companies established in a tax haven country;
- shares and participations in non-resident real property companies would be considered to be French property and would thus be subjected to French inheritance and gift tax;
- CGI, Art. 902 A and Art. 5(IV) of the Finance Law for 1982 regarding the net wealth tax would be deleted.

The parliamentary debates did not shed much light on the new measures. However, during these debates the rate of "exit tax" was reduced from 20% to 15%.

We will now discuss the most important provisions of the new legislation which have been commented upon by the Administrative Ruling of 13 April 1983 (Official Bulletin of the Tax Administration, No. 7 Q-1-83).

(1) *The annual 3% tax*

As of 1 January 1983, legal entities whose registered head office is situated outside France and which possess French-situs real property are, in principle, subject to an annual tax of 3% on the market value of such property. Apart from a number of exceptions, which are discussed below, the tax is levied on all legal entities having their registered head office outside of France, regardless of their legal form, i.e. they can be corporations, partnerships, etc. However, the following legal entities are exempt:

- legal entities which own French-situs real property representing less than 50% of their French-situs assets (Real property which is used for the entities' *own* industrial, commercial, agricultural or other business purposes is not affected by the new law);
- legal entities who have their registered head office in a country with which France has concluded a treaty for administrative assistance in preventing tax fraud and tax evasion provided that they report each year to the French tax authorities;
  - the location, the description and the value of the property (ies) held on 1 January of the pertinent year;
  - the identity and the addresses of the shareholders or participants; and
  - the number of shares or participations held by them.

  The tax is, therefore, not due if the tax authorities know the names of the shareholders of and participants in the legal entity and can use the administrative assistance provided for in tax treaties to check the accuracy of their information. In Western Europe Switzerland is the only country whose tax treaty with France does not contain an administrative assistance clause;
- international organizations, foreign sovereign States and foreign public institutions;
- pension funds and other non-profit organizations which perform non-remunerative activities of a social, philantropic, educational or cultural nature and which prove that these activities justify the ownership of real property in France.

The tax concerns, in principle, buildings and unimproved land situated in France as well as real property rights, such as usufruct, right of enjoyment, etc. It is immaterial whether the property has been rented to a third party or not. The tax is also due if a non-resident company owns real property or real property rights through a French real property holding company.

The tax is levied at the rate of 3% on the market value of French-situs real property on 1 January of the pertinent year. The French tax authorities define the term "market value" as the price which could or should normally be charged at the sale of such property.

As stated above, a non-resident entity must submit annually (on or before 15 May) a return including the location of the property, its description, and the market value of the French-situs real property or real property rights which it possessed on 1 January of the pertinent year. This return must be submitted either to the Tax Collector of the district where the property is situated or to the Center for Non-Residents in Paris, if a number of local tax collectors are involved. As is the case for the wealth tax, the tax must be paid when making the declaration.

The non-resident legal entity is the person who owes the tax. However, if the property is held through an intermediary person, the latter is severally liable for the payment of the tax. In addition, the fiscal representative which the non-resident taxpayer must appoint when selling real property situated in France for the imposition of the 33⅓% "prélèvement" is responsible for the payment of any tax still due for the year in which the sale took place if he has expressly bound himself.

Note that the tax is not deductible for purposes of the individual income tax or corporate income tax which remains due under the normal rules of French tax law.

34. The acquisition of real property in France is subject to various registration taxes. Their aggregate rates vary from "département" to "department" from approximately 18% to 19%. A reduced rate (approximately 7%) applies to dwelling houses.

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The French tax authorities may request the non-resident entity which is subject to the 3% annual tax to appoint within 90 days from the receipt of such a request a fiscal representative in France. This person must be authorized to receive the communications from the French tax authorities with respect to the taxable base of the tax, its collection and possible litigation.[35] However, he will *not* be liable for the payment of the tax debts of the entity. It is noted that the representative may submit a return for the entity only if he has received express authorization.

The provisions, regarding the determination of the tax due in case of non-declaration, which are applicable to the net wealth tax also apply to the 3% annual tax. In such a case, the tax authorities may unilaterally determine the tax to be paid provided they have sent the taxpayer a summons and the latter did not respond within 2 months.[36]

Otherwise, the 3% annual tax is collected in conformity with the provisions which exist for registration taxes and the same penalties apply. However, two special provisions which are also applicable to the net wealth tax have been provided for by the Finance Law for 1983, i.e.:

- the rate of the penalty for late payment provided for in CGI, Art. 1727 is increased from 3% to 10% of the tax due for the first month that the taxpayer is late. For the other months the rate remains 1%;
- if the tax authorities were forced to unilaterally determine the amount of tax due (see above) the penalty may not be less than 30% of the tax which was paid late.

Under Art. 4(1)(2) of the Finance Law for 1983, any shares or participations in legal entities having their registered head office abroad whose assets mainly consist of real property or real property rights situated in France, are deemed to be French property and are subject to French net wealth tax, inheritance and gift tax. However, if such an entity has been subject to the 3% annual tax, its *non-resident* shareholders or participants are subject to neither the wealth tax, the inheritance tax nor the gift tax, with respect to the shares or participations which they own. According to the tax authorities, they remain subject to the 33⅓% "prélèvement" in case they sell their shares or participations.[37] On the other hand, the 3% annual tax does not replace the corporate income tax on rents which remain due.[38] These provisions have now been codified as CGI, Arts. 990 A through 990 G.

(2) *The 15% "exit tax"*

In order to favour the removal of the tax shelters of non-resident legal entities, the Finance Law for 1983 introduced a 15% lump-sum tax on the value of French-situs real property owned by non-resident legal entities, which would replace any other taxes normally due at the distribution of such assets to its shareholders or participants. Initially, such favoured tax treatment was available until 31 December 1983, but this date was first changed to 15 May 1984[39] and later to 15 September 1984.[40]

The legal entities concerned where those that fell under the scope of the 3% capital tax, whether they were effectively subject to this tax or exempt. In order to become eligible for the regime of the "exit tax", the non-resident legal entity had to transfer real property which it owned to an individual who was a shareholder or participant in the entity concerned. Such a transfer could not be the result of the sale of the property to one or more shareholders or participants. The transfer had to be effected through either a liquidation of the entity concerned or by a partial distribution of its assets. However, real property acquired after 1 January 1983 did not qualify for such a privileged transfer. The document pertaining to the transfer of the property had to be registered *before* 15 September 1984. The "exit tax" would only become payable after express election by the taxpayer at the moment the document was registered. Of course, where such election was not made, the normal taxes were due.

The 15% "exit tax" was computed on the market value of the property on 1 January 1983. The tax not only became due at the moment of registration, but also had to be paid immediately.

As stated by the tax authorities,[41] the transfer had to be effected without any consideration in cash or in kind paid to the legal entity making the transfer.

This condition was considered to be met if the shareholder or participant waived any debts which the entity owed to these shareholders or participants. However, the situation would be different if those debts were incurred as of the moment that the Finance Law 1983 became effective and were, considering their amount, clearly an advance payment for the property transferred.

Similarly, the regime of the "exit tax" would be refused if after the event the shareholders or participants sold the property soon after it had been transferred to them.

A special case was where a non-resident legal entity (A) would hold a participation of more than 50% in a French real property company (B) which was deemed to be an "intermediary" company, of which the remainder of its shares were held by trust companies (C and D). The question which was raised was whether it would be possible to apply for the 15% "exit tax" when total real property would be transferred to an individual person (X), shareholder of

35. CGI, Art. 223 quinquies A.
36. Livre des Procédures Fiscales, Art. L. 76.
37. CGI, Art. 244 bis A.
38. See II.A.1.a. above.
39. Finance Law 1984, Art. 31 (I)(4).
40. This was effected by a simple administrative measure. The Finance Minister replied in Parliament to Mr. Colonna, M.P., that "when amending the tax regime of real property owned in France by non-resident companies, the legislature wished to allow such companies to be exempt from the 3% tax on the market value which it introduced by transferring the property on or before 15 May 1984. For reasons of efficiency, it was decided that this date would be moved to 15 September 1984". Thus the postponement of the "fatal" date was not even announced through an official announcement, but only through an answer given to a Member of Parliament to a question asked on 9 April 1984 *Official Journal, debates of the Lower House (Assemblée Nationale)*, 7 May 1984 at 2,136).
41. Supplementary Ruling regarding the 15% "exit tax" of 9 February 1984 (Official Bulletin No. 7 Q-1-84).

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the non-resident legal entity (A) although the individual (X) was not a shareholder of either one of the trust companies (C and D). The tax authorities gave as their opinion that under these circumstances legal entity A could only transfer its *shares* in company B to X under the imposition of the 15% "exit tax", these shares being deemed to be real property. With respect to trust companies C and D it was assumed that they had behaved vis-à-vis third parties as if they were the real owners of part of the capital of company B. C and D were non-resident companies, they could also transfer their shares in B under payment of the "exit tax" to X. X would then be the sole shareholder of B and it would be possible to liquidate B and transfer the property to X without any capital gains tax becoming due.

The option for the payment of the 15% "exit tax" had to be made at the bottom of the document which pertains to the transfer of the property. Such option could be phrased as follows: "parties concerned express their wish to opt for the imposition of the 15% tax provided for in CGI, Art. 990 H". The tax became payable immediately at the registration of the document concerned.

In practice, the French notary took care of its payment and also paid the fees for the registration of the document which he charged to his client as well as his own fee which was a function of the market value of the property concerned.

The transfer of real property after the payment of the 15% "exit tax" exempted the taxpayer from the 3% annual tax payable during 1983 and 1984. If the taxpayer had already paid the 3% annual tax in 1983, or in 1983 *and* 1984, he could credit the tax paid against the 15% "exit tax", so that in such a case only 12% or 9% "exit tax" would be due. The 15% "exit tax" exempted the non-resident legal entities and their shareholders or participants receiving the property from any tax connected with such a transaction. The exemption concerned the imposition of registration tax due on the transfer of shares or participations representing real property to the shareholders and participants or the registration tax which was due upon liquidation of the entity followed by the transfer of its assets, and also the "prélèvement" and corporate income tax on the capital gains.[42]

In addition, unless the imposition of tax resulted from a tax audit begun or announced before 19 October 1982 (i.e. the date on which the text of the bill was submitted to the Lower House), the payment of the 15% tax exempted the legal entities concerned as well as their shareholders or participants from any tax penalties which could be imposed with respect to the property transferred during the period preceding 19 October 1982.

This exemption essentially concerned the corporate income tax to which the legal entity could be subjected during the period for which the statute of limitations had not yet expired, either the corporate income tax computed under the "normal" provisions or under CGI, Art. 209 A.[43] It also concerned the substitute withholding tax imposed under CGI, Art. 115 quinquies, and, with respect to individual taxpayers, it concerned the net wealth tax levied on the value of the shares or participations representing the real property transferred.

In other words, the Finance Law for 1983 provided that the imposition of a tax and penalties resulting from tax audits begun on or after 19 October 1982 was waived provided that the non-resident legal entity transferred its real property to one or more of its shareholders or participations before 15 September 1984, and that it paid 15% tax on the market value of such assets.

It is rather surprising that no amnesty at all – not even partial amnesty – was offered with respect to earlier tax audits. The result was that entities which succeeded in escaping notice by the French tax authorities or which resorted to a tax office whose agents were somewhat less zealous, received favoured treatment under the law! It is for this reason that the tax authorities were authorized to remedy this situation to a certain extent by an unpublished ministerial ruling on 22 February 1984 (see B. below).

(3) *Changes of certain transfer taxes*

In order to discourage non-resident legal entities established in tax haven countries from acquiring dwelling houses in France, the reduced 2.6% rate of transfer tax (registration tax) provided for in CGI, Art. 710 was not applicable to non-resident entities established in a country with which France had *not* concluded a treaty containing a mutual assistance clause under which the Contracting States could combat tax fraud and tax evasion. In other words, if such an entity purchased a dwelling house in France, it was, as of 1 January 1983, subject to the various transfer taxes currently totalling 18%-19%.[44] This also applied to garages and land destined for the building which normally benefit from the same rate reduction as dwelling houses.[45]

The provisions of the Finance Law for 1983 also had an impact on the so-called "territoriality" rule regarding French transfer tax (registration taxes), in particular to those imposed at death and in the case of gifts (inheritance and gift taxes) and the French net wealth tax. By virtue of CGI, Art. 750 ter, non-residents are only subject to inheritance tax, gift tax or net wealth tax with respect to movable and immovable property situated in France, including shares and participations issued by French companies which are deemed to be located in France. However, shares and participations which are issued by a non-resident company are normally not considered to be situated in France and are consequently not subject to these taxes. The Finance Law for 1983, Art. 4 added a new category of property situated in France to existing legislation by providing that, henceforth, the shares and participations issued by non-resident companies whose assets consist mainly (i.e. more than 50%) of real property and real property rights situated in France, are also deemed to be situated in France. In order to establish whether a

42. CGI, Art. 244 bis A. See also not 7, 19, 23 and accompanying texts.
43. Note that the provisions of CGI, Art 209 A remained applicable to accounting years closed before 1 January 1982.
44. CGI, Art. 783. See note 34.
45. CGI, Art. 711.

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non-resident company's assets consist mainly of real property situated in France (à préponderance immobilière), the value of the company's total assets situated in France (and not total assets in France and abroad) must be compared with the value of its real property and real property rights situated in France (with the exception of French real property which it owns for purposes of an industrial, commercial or any other business enterprise). If the value of the French real property and real property rights exceed 50% of the total value of the French assets, the non-resident company's shares or participations are deemed to be situated in France. However, their full value is not subject to French tax, but rather that part of the value which bears the same ratio to the full value as the value of the real property situated in France bears to the value of world-wide assets. This is illustrated in example 4.

Example 4

Assume Company A owns assets valued at 51,000,000 Ffrs. which are composed of:

- Real property (other than real property which the company requires for its industrial, commercial or any other business enterprise), real property rights and shares or participations of companies whose assets mainly consist of real property:

	Ffrs.	Ffrs.
– situated in France	10,000,000	30,000,000
– situated outside France	20,000,000	
– Other assets:		
– situated in France	6,000,000	
– situated outside France	15,000,000	21,000,000
Total		51,000,000

The real property, real property rights and shares and participations in companies whose assets consist mainly of real property situated in France represent 10/16 or 62.5% of the French assets so that Company A is itself a company whose assets consist mainly of real property situated in France.

The value of the shares of Company A which has to be taken into account for purposes of French tax is 10/51, or 19.6%

The new provisions applied to gifts made and inheritances acquired on or after 1 January 1983. With respect to the net wealth tax these provisions applied for the first time to the tax due in 1983.

A special Ruling of 19 April 1983 commented on these new provisions.[46]

However, the tax authorities gave no details on the practical application of the text. The following may be assumed. As had been stated above, companies which have their registered head office in a country which has concluded a treaty with France for administrative assistance may avoid the annual 3% tax provided that they file by 15 May of each year a return in which they indicate the identity of their shareholders or participants. Thus the French tax authorities obtain the legal means to check the correctness of the information supplied by the taxpayers through the administrative assistance. The tax authorities will also be enabled to impose gift tax or inheritance tax, each time there is a change in the list of the shareholders/participants due to a transfer through a donation or at the death of a person as illustrated in example 5.

Example 5

Assume that X donates 20% of the shares of company A (see example 4) to Y who replaces X as a shareholder of Company A. It is further assumed that X and Y are not related so that the 60% rate applies. Y must pay a gift tax of:

51,000,000 × 19.6% × 20% × 60% or 1,199,520 Ffrs.

B. The relief offered by the tax authorities on 22 February 1984

As stated before, on 7 May 1984 the Finance Minister decided to change the date for transfering real property to 15 September 1984. However, the statement of the Minister also revealed that other relief would be accorded to non-resident real property companies, provided that certain conditions were fulfilled.

The new regime under which the payment of 15% tax on the market value of the real property transferred was very advantageous since it replaced the annual 3% tax, back taxes and penalties which might be due as a result of a tax audit announced after 18 October 1982. The tax authorities realized that, nevertheless, it could be difficult for non-resident real property companies which merely acted as intermediaries to liquidate where they could not avail themselves of the amnesty with respect to taxes and exchange rate regulations and for this reason it was decided to give a certain relief to such "victims" of CGI, Art. 209 A (not for "ordinary" corporate income tax accruing from rent and not challenged). In order to obtain this relief, the companies in question had to address themselves to the tax authorities who were instructed to give relief. The maximum amount of back taxes plus penalties were not to exceed 10% of the market value of the property transferred. Similarly the penalties for violating the customs and exchange regulations (especially for "French-residents" in the meaning of these regulations) were also limited to 10% of the market value of the property concerned, so that the maximum amount would not exceed 15% + 10% + 10% or 35% of the property. This relief was also accorded to companies established in countries with which France had concluded a treaty containing a mutual administrative assistance clause if such companies retained their property but supplied the information which exempted them from the 3% annual tax and declared before 15 September 1984 any violations of the customs and exchange regulations they might have committed.

46. Ruling of 19 April 1983 published in the Official Bulletin No. 7 G-5-83.

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The Finance Law for 1983 therefore did not provide for amnesty for companies which had been subject to a tax audit before 19 October 1982. However, considering the fact that a relatively large number of companies were audited or were being audited before 19 October 1982 and considering the fact that large amounts of tax and penalties would thus become due, the Ministerial decision of 22 February 1984 provided for a relief scheme to settle these matters.

(1) *Conditions to be met*

Regardless of the circumstances, the non-resident company wishing to benefit from the relief provisions must conclude some agreement with the French tax authorities under which it discontinued any litigation against the latter and waived its rights with respect to any future litigation.

The relief was in the first place intended for companies which transferred their property under the regime of the 15% tax. (With respect to companies which were established in a country with which France had concluded a treaty containing a clause for the mutual assistance in administrative matters, such transfer was also possible as mentioned above but not absolutely required.) If such companies did not elect for the payment of the 15% tax, they must supply the information, which they would also be required to give to be exempt from the 3% annual tax (in particular they must supply the names and the addresses of their shareholders or participants) and they must pay within two months the final instalment of taxes due.

(2) *Principles applicable for the settling of current affairs*

These principles varied according to the adjustments of tax the authorities wished to make:

(a) if the non-declared rent was less than 20% of real annual rental value of the property with respect to any tax year concerned in a tax audit, the tax authorities would not require any tax adjustment for that year;
(b) if the non-declared rent was more than 20% of annual rental value, the corporate income tax due under CGI, Art. 209 A would be imposed on an income equal to the real annual rental value of the property increased by interest for late payment up to a maximum of 25% of the tax due.

The provisions of the Ruling of 8 February 1982 with respect to the substitute withholding tax and other taxes (e.g. the registration tax on lease contracts) were applicable, but the penalty for late payment would be limited to 50% of the amount of tax due.

Under the relief scheme, the following tax reductions were available:

(a) if the total amount of back taxes and penalties did not exceed 10% of the market value of the property used as the base on which the 15% tax was imposed (or if it did not exceed 10% of the real value of the property in case of a company which retained its property) no reduction of tax was available;
(b) if the amount of back taxes and penalties exceeded the percentages indicated above, the taxes and penalties were limited to 10% of the market value of the property.

(3) *Practical application of the relief provisions*

The relief provisions were – as stated above – only of significance in situations in which a tax audit was completed or started before 18 October 1982. In practice it was important to distinguish between cases in which the Collector of the Treasury had already received corporate income tax and those in which he had not.[47] The tax authorities had generally stated that they would *not systematically* review the situation of non-resident entities which had been subjected to tax under CGI, Art. 209 A, provided that such entities had not started an appeal procedure.

However, if a non-resident met the above conditions and *requested* the application of the relief provisions, these would generally be accorded under the conditions set out above. In other words, non-resident companies which were not aware of the relief provisions stated in the Ministerial Statement of 7 May 1984 would remain heavily taxed to the benefit of the French Treasury. This would also be the case where the non-resident company had agreed to a less advantageous reduction of its tax liability. Furthermore, it may be expected that if the conditions of the tax authorities are not met, the taxes initially assessed or envisaged will be imposed.

C. Brief study of the tax regimes which are possible as of 15 September 1984

Assume that in 1984 a non-resident real property company possessed real property in France valued at 5,000,000 Ffrs. Various situations in which the company liquidates and transfers the property or does not liquidate and retains the property are studied below.

1. The non-resident company "disappears"

a. *Taxes imposed on the company*

The company can "disappear" for purposes of French tax:

– by paying the 15% "exit" tax on the market value of the property, i.e.: 15% × 5,000,000 or 75,000 Ffrs. increased by the fees payable to a notary and the fees due for the registration of the transfer. If no tax audit has taken place before 10 October 1982, the 15% tax exempts the company from corporate income tax and transfer tax (registration tax) at the transfer of the property. If this is not the case it will be possible to obtain a relief

47. When a company had already discharged its debt related to the application of CGI, Art. 209 A, many Collectors of the Treasury made it difficult to grant a refund in the name of the assignee money received from a company with a separate legal personality.

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as provided for by the tax authorities. This is the only situation possible where the Treasury has in advance safeguarded its rights by subjecting the property to a legal mortgage. However, if the Treasury has omitted to impose a legal mortgage on the property, it will be possible to transfer the good and only pay the ordinary transfer tax at 7%.[48] The French tax authorities will not be in a position to impose any other tax (especially corporate income tax due and not paid);

- by transferring the asset or liquidating which will result in the imposition of a "liquidation tax" (droit de partage) of 1% of the market value of the property or 50,000 Ffrs. The 33⅓% prélèvement is unavoidably due on the capital gains realized.[49] The corporate income tax (at the rate of 15%) on the capital gain and the rent received could be ignored;
- by the sale of the property situated in France, in which case the transfer tax (registration tax) is generally payable by the purchaser. If the non-resident company is a corporation or a limited liability company, it is subject to the 33⅓% prélèvement which may be credited against the corporate income tax imposed on the capital gain (at 50% if the non-resident company does not have any other property in France) and on any rent received where the company does not "forget" it. If the property was held by a non-resident civil partnership (société civile), the 33⅓% prélèvement is imposed on its partners who are subject to further income tax if they are resident in France and are exempt from further income tax if they are resident abroad.

b. *Taxes imposed on the individuals receiving the property*

Any person who receives property becomes, as of 1985, subject to the net wealth tax (up to and including 1986). If there were more persons, they might or might not become subject to the net wealth tax depending on the value they received (i.e. whether the value each one received was higher than the threshold for the new wealth tax: 3,500,000 Ffrs. in 1985).

2. The non-resident company "continues"

a. *Tax consequences to non-resident companies exempted from the 3% tax*

Such companies must file a special return in order to be exempted from the 3% annual tax.

The following situations may be distinguished:

- the property was placed at the disposal of one or more of the company's shareholders: the corporate income tax was calculated from the gross value of the benefit accorded to the shareholder (see II.A.1.b.). The company could also be subject to the substitute withholding tax and the shareholder(s) could be subject to net wealth tax;
- the property is rented to a third party: the company is subject to corporate income tax calculated from the gross amount of rent received (see II.A.1.a.). The company is also subject to the lease tax (registration tax) or the value added tax, the substitute withholding tax, and its shareholders can be subject to the net wealth tax.

In the case where shares of immovable property situated in France are transferred to a new shareholder who has been reported to the French tax authorities through a declaration made by the non-resident real property company, the new shareholder would be subject to inheritance or gift tax if the shares or the property came into an estate or were donated. The seller of the shares or the property would be subject to the 33⅓% "prélèvement". If the seller is a non-resident individual, the payment of the "prélèvement" satisfies further payment of individual income tax.

b. *Tax consequences to taxable non-resident companies*

A non-resident real property company may be subject to French tax because (i) it has not filed the special return although it has its registered head office in a country with which France has concluded a treaty containing a mutual administrative assistance clause, or (ii) because it has its registered head office in a tax haven country. Again the following two situations may be distinguished:

- the property is placed at the disposal of one or more of the company's shareholders: the payment of the 3% annual tax satisfies the payment of the corporate income tax and the wealth tax. However, prominent tax experts in this field are of the opinion that there is no absolute guarantee that the identity of the real owner can be kept from the French tax authorities since with respect to local taxes – in particular the dwelling tax (taxe d'habitation) – the tax authorities are entitled to demand that the name of the person occupying (if he is the owner) the dwelling be disclosed;
- the property is rented to a third party: notwithstanding the payment of the 3% annual tax, the non-resident company must pay corporate income tax calculated from the gross amount of rents received, as well as the lease tax or the value added tax.

In the case where shares are sold, no tax is due since the tax authorities can not be aware of such a sale. However, if the non-resident sells the property situated in France it is subject to the 33⅓% "prélèvement" and in principle it is also subject to the corporate income tax on the capital gain (at the rate of 50% if the company does not own any other property in France). In the two situations distinguished above, the taxable base for the corporate income tax was:

- computed in the normal manner if the company has received rental income and regularly filed re-

48. See note 34.
49. For the payment of this tax the non-resident company must appoint a fiscal representative in France, which will also be responsible for the payment of the 3% annual tax over 1984 (not over the preceding year).

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turns in which depreciation had been taken into account;
- computed on the difference between the purchase price and the sales price in cases where the property was placed at the disposal of its shareholders.

IV. CONCLUSION

It is, therefore, possible for persons who often enjoy the benefits of shelter companies to continue to use non-resident companies to acquire French-situs real property, provided that these companies are established in a country with which France has concluded a treaty containing a mutual administrative assistance clause. In other words, the companies must be prepared to abandon the anonymity of their investments. If they do not wish to do so they will, taking into account the 3% annual tax and other taxes, have paid an aggregate amount of taxes equal to the original investment in approximately 20 years! The best solution is, therefore, to invest directly in French-situs real property or through a French civil partnership (société civile). Of course, the new tax regime has had adverse repercussions on the luxury real property market. Therefore, during the debates on the Finance Law for 1983, a Member of Parliament stated:

> I believe that one should be aware that this amendment will result in a conflict of one's duties. On the one hand there is the duty to combat tax evasion, and in particular in its most serious form, the illegal export of capital through base companies established in tax haven countries. On the other hand the duty not to disturb the luxury real property market through these measures, since it is not only French citizens who use these base companies but also a large number of foreign citizens. By trying to prevent the illegal exportation of French capital, we risk dealing a severe blow to foreign investment in luxury real property in France.
> For moral reasons I will vote for the amendment, but I hope that the Government will find some solution that does not affect too seriously the luxury real property market, by somehow making a distinction between residents of France and non-residents.[50]

It seems that this suggestion has not been heeded. If, however, the 3% tax were to be reduced, such reduction in combination with the wealth tax deletion, would effect some improvement of the situation!

50. Mr. Jacques Marette, *Official Journal, debates of the Lower House (Assemblée Nationale)*, 27 October 1982 at 6,396.

Conference Diary

MARCH 1987

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MAY 1987

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ZIMBABWE:

Investment by Foreign Companies

By D.G. Murphy

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The purpose of this article is to illustrate the effects of the Income Tax Act and the Capital Gains Tax Act of Zimbabwe and of the double taxation agreement (DTA) between Zimbabwe and the United Kingdom on different investments that might be made by foreign companies in Zimbabwe. These investments are those which give rise to:

1. profits or capital gains from the carrying on of business in Zimbabwe;
2. dividends and capital gains from shares;
3. interest and capital gains from investments; and
4. royalties and capital gains from assets that can give rise to royalties.

In order to facilitate the making of comparisons, the figure of Z$ 100,000 is used in all illustrations as representing the annual income. And in all illustrations of the capital gains tax (CGT) a transfer price of Z$ 200,000 is used and the total figure of CGT deductions is taken as Z$ 100,000.

For each of the four categories listed above, separate illustrations are given for a foreign company which is both resident and subject to tax in the U.K. and for a foreign company which is not resident nor subject to tax in the U.K. It must be here explained that at the time of writing Zimbabwe has only two DTAs. The second DTA is with the Republic of South Africa. Any effect that this DTA might have is not dealt with in this article.

1. PROFITS OR CAPITAL GAINS FROM THE CARRYING ON OF BUSINESS IN ZIMBABWE BY A FOREIGN COMPANY

	Profit *Z$*	*Capital gain* *Z$*
Zimbabwean taxable income	100,000	--
Zimbabwean capital gain	--	100,000
Zimbabwean income tax 1985/86 rate 52.875%	52,875	--
Zimbabwean branch profits tax 1985/86 rate 8.4%	8,400	--
Zimbabwean CGT 1985/86 30%	--	30,000
Overall rate of tax	61.275%	30%

Here we are dealing with the foreign company itself trading in Zimbabwe, probably as a branch or other form of permanent establishment, but it should be noted that Section 12(1)(a) of the Income Tax Act includes in taxable income any profit from the sale of goods if the contract of sale was made in Zimbabwe and this is so whether or not the company has any presence in Zimbabwe. The Income Tax Act allows the deduction of revenue expenditure incurred for the purpose of earning the taxable profit and no distinction is made between expenditure incurred inside and outside Zimbabwe. The company could therefore claim deductions for its foreign expenditure incurred in earning the profit that is subject to Zimbabwean income tax. However, should this include expenditures of a technical, managerial, administrative or consultative nature a tax of 20% is levied on such part of it. This tax is levied only if and when this part of the expenditures is remitted from Zimbabwe.

Only "specified assets" are subject to CGT. These are: immovable property; any bond capable of being sold in a share market or exchange; and any debenture, share or stock, or right possessed by reason of participation in any unit trust, whether or not capable of being sold in a share market or exchange. Taxable transfers include exchanges, donations, expropriations and proceeds from the maturity, redemption or liquidation of chargeable investments or from the damage or destruction of immovable property. Allowable as deductions in arriving at the chargeable capital gain are expenditure on acquisition, construction, ad-

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dition, alteration and improvement, together with a notional allowance of 5%, for each year or part of a year, of such expenditure. The CGT Act contains provisions that are designed to avoid the duplication for CGT purposes of accruals and expenses which are accountable for income tax purposes. It also has provisions which permit, in certain circumstances, assets to be transferred between companies under the same control without any immediate tax consequences. Securities for loans to the State, a local authority or statutory corporation are exempt from CGT.

The Income Tax Act and the CGT Act each allows losses to be established and carried forward for set-off against future taxable income or capital gains without any limit as to time. But income tax losses cannot be set off against capital gains or vice versa.

Had the foreign company been a U.K. company subject to U.K. tax on its Zimbabwean taxable profit of Z$ 100,000, the Zimbabwean income tax would be reduced to:

	Z$
Zimbabwean income tax	
1985/86 rate 52.875%	52,875
Zimbabwean branch profits tax	
1985/86 rate 2.5%	2,500
Overall rate of tax	55.375%

The saving of 5.9% (61.275 – 55.375) comes about by virtue of Article 24(2) of the DTA which reduces the branch profits tax from 8.4% to 2.5%. Section 12(1)(a) would be inoperative since profits from the sale of goods that are not attributable to a permanent establishment are exempt by virtue of Art. 7(1). Art. 7(3) expressly states that there shall be allowed as deductions expenses which are incurred for the purposes of the permanent establishment, including an allocation of executive and general administrative expenses incurred for the purpose of the U.K. enterprise as a whole, whether in Zimbabwe or elsewhere. Art. 24(2) stipulates that the Zimbabwean taxation – which by virtue of Art. 24(6) means taxes of every kind and description – on the permanent establishment shall not be less favourably levied than the taxation levied on Zimbabwean enterprises carrying on the same activities except that Zimbabwe can levy the additional 2.5% tax, which it does by way of a branch profits tax. It would therefore appear that the 20% tax on remittances from Zimbabwe of certain expenditures allocated to the permanent establishment could not be charged. If this tax were regarded as leviable on the U.K. head office, as distinguished from its Zimbabwean permanent establishment, Art. 7(1) might cancel the levy of this 20% tax. The remittances form part of the head office profits and are attributable to the activities of the head office, not to the activities of the permanent establishment. It is understood that the Zimbabwean tax authorities do not agree that the 20% tax on remittances is not leviable. There is no official publication on this matter. It is submitted that Art. 24(2), as read with Art. 24(6), establishes non-liability. In relation to Art. 7(1) there is the argument that the tax is a tax on remittances and as such is not a tax as defined in Art. 1(b) of the DTA. But this argument ignores the similarity between a branch profits tax and non-resident shareholders' tax, which is expressly specified in Art. 2(1)(b), and the similarity between the non-residents' tax on fees and the non-residents' tax on remittances. The tax on fees came into existence after the DTA had been negotiated. The tax authorities accept, as they are bound to by Art. 2(2), that the tax on fees is a tax for the purposes of the DTA. It seems undeniable that the tax on remittances, which was introduced at exactly the same time as the tax on fees, is substantially similar and is, therefore, in terms of Art. 2(2) a tax for the purposes of the DTA.

The profits, income and capital gains of the U.K. company which remain liable to Zimbabwean tax under the DTA are treated as arising from Zimbabwean sources for the purposes of pinpointing which of the two countries is to allow relief from double taxation (Art. 23(3)). In terms of Art. 23(1), the U.K. must grant relief for Zimbabwean tax payable whether directly or by deduction, on profits, income or chargeable gains from sources within Zimbabwe.

2. DIVIDENDS AND CAPITAL GAINS FROM SHARES RECEIVED BY A FOREIGN COMPANY

	Dividends Z$	*Capital gain Z$*
Amount	100,000	100,000
Zimbabwean income tax	Nil	
Zimbabwean non-resident shareholders' tax (N.R.S.T.) current rate 20%	20,000	
Zimbabwean CGT 1985/86 rate 30%	– –	30,000
Overall rate of tax	20%	30%

With the exception of some dividends from building societies all Zimbabwean dividends are, under the present legislation, exempt from income tax. Capital gains on shares are subject to CGT only if the gains are from an actual source in Zimbabwe.

If the shareholder, entitled to the gross dividend of Z$ 100,000, was a U.K. company subject to U.K. tax on the dividend, Art. 10(4) of the DTA would operate to reduce the rate of N.R.S.T. from 20% to 5%, but only if the shareholder is a company that controls, directly or indirectly, at least 25% of the voting power in the company paying the dividend.

Another interesting aspect of Article 10(4) is that an increase in the rate of N.S.R.T., beyond 20%, enacted in future Zimbabwean legislation would not be effective in relation to the U.K. company unless a corresponding enabling amendment were also made to the DTA. However, the benefits enjoyable under Article 10(4) are lost if the shareholder is carrying on business in Zimbabwe through a permanent establishment with which the shares were effectively connected (Art. 10(6)). The Zimbabwean dividends

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receivable by the U.K. company might form part of its distributable profits, but Zimbabwe is not permitted to pursue any such distribution made by the U.K. company to exact further tax except in the hands of its own residents or in the hands of a Zimbabwean permanent establishment with which the shares in the U.K. company are effectively connected (Art. 10(7)).

Double taxation relief for the N.R.S.T. would be allowed against U.K. tax in terms of Art. 23(1). If the control exercisable by the shareholding company was at least 10% of the voting power, relief would also be allowable by the U.K. for the underlying Zimbabwean tax payable on the profits out of which the dividend was paid. For example, if the gross dividend of Z$ 100,000 were paid out of profits subject to Zimbabwean income tax at the 1985/86 rate, the underlying tax would amount to Z$ 112,202 being 52.875% of taxable profits of Z$ 212,202. The amount of Zimbabwean N.R.S.T. and income tax ranking for double taxation relief would then be either Z$ 117,202 on the net dividend of Z$ 95,000 or Z$ 132,202 on the net dividend of Z$ 80,000. The amount of relief actually allowed is determinable in accordance with the provisions of the law of the U.K. regarding the allowance of foreign tax as a credit against U.K. tax in so far as these provisions do not conflict with the general principle laid down in Art. 23.

Art. 23 also provides for double taxation relief for CGT payable in respect of chargeable transactions involving shares. However, Art. 14(4) contains a noteworthy exception to the more usual type of relief provided by Art. 23. Art. 14(4) exempts from Zimbabwean CGT any capital gain made from the alienation of shares in a company other than a company the assets of which consist principally of immovable property, as set out in Art. 6 of the DTA. This exemption is withdrawn if the shares formed part of the business property of a Zimbabwean permanent establishment. Art. 14(4) does not impinge upon Zimbabwe's right to levy N.R.S.T. on dividends and it should be noted that "dividend" is defined for N.R.S.T. purposes to mean any amount distributed by a company incorporated in Zimbabwe to its shareholders, but excluding bonus shares or any amount which is a return of the amount received by the company for its shares.

3. INTEREST AND CAPITAL GAINS FROM INVESTMENTS RECEIVED BY A FOREIGN COMPANY

	Interest *Z$*	*Capital gain* *Z$*
Zimbabwean taxable income	100,000	--
Zimbabwean capital gain	--	100,000
Zimbabwean income tax 1985/86 rate 52.875%	52,875	--
Zimbabwean branch profits tax 1985/86 rate 8.4%	8,400	--
Zimbabwean non-residents' rate on interest (N.R.T.I.) current rate 10%	10,000	--
Zimbabwean relief from the levy of both income tax and N.R.T.I.	(10,000)	--
Zimbabwean CGT 1985/86 rate 30%	--	30,000
Overall rate of tax	61.275%	30%

Branch profits tax is leviable on the taxable income of foreign companies whether they have a branch in Zimbabwe or not. The name of the tax is somewhat misleading in this respect.

Only interest from a source within Zimbabwe is subject to tax in the hands of a foreign company resident outside Zimbabwe. Source in this context does not mean the place where the debtor resides or where the interest is payable. It is used figuratively and means the cause which gave rise to the interest, i.e. the originating cause. Once the originating cause has been identified it must then be located to see whether it is inside or outside Zimbabwe. The originating cause of interest on a capital investment in the form of a loan of money is the provision of credit by the lender and the source of the interest is therefore located at the place where the lender provided the borrower with the loan funds. It follows that, if the borrower took possession of the funds outside Zimbabwe, no Zimbabwean tax is chargeable on the interest payable to the non-resident.

Certain interest from sources within Zimbabwe is made exempt from one or more of the taxes by virtue of specific exemptions contained in the Income Tax Act. It helps to explain these exemptions if they are separated into the following three groups:

1. interest on deposits with the Post Office Savings Bank of Zimbabwe, on State loans which confer exemption as a condition, on class "C" shares issued by building societies, and on so much of any tax reserve certificate as is accepted in payment of tax or is applied to the purchase of further tax reserve certificates;
2. interest on any loan to the State, a company (all the shares of which are owned by the State), a local authority or to a statutory corporation;
3. interest on so much of any loan made to any borrower carrying on mining operations or undertaking prospecting or exploratory works for the purpose of acquiring rights to mine minerals as is used by the borrower on such operations or undertakings in Zimbabwe.

The interest in group 1 is, without any exception, always exempt from income tax, branch profits tax and N.R.T.I. The interest in groups 2 and 3 is exempt from income tax and branch profits tax in the hands of a non-resident, but only if the non-resident is not carrying on business in Zimbabwe. It is subject to N.R.T.I. except that interest from a statutory corporation in respect of a particular loan can be specified as exempt from this withholding tax by ministerial notice in the Government Gazette. For example, in General Notice 418 of 1986, in the Gazette dated 27 June 1986, the interest payable by the Zimbabwean Posts and Telecommunications Corporation in respect of a loan agreement for DM 12,000,000 with Kreditanstalt für

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Wiederaufbau was specified as exempt from N.R.T.I. (As pointed out earlier, when explaining the meaning of source in relation to interest, non-liability to income tax, branch profits tax and N.R.T.I. is automatic for interest that is payable to a non-resident and is not from an actual source within Zimbabwe.) The exemptions for interest in both group 2 and group 3 are withdrawn if the lender is a company that is under the control, through exercisable share-voting rights, of a person who is either ordinarily resident or carrying on business in Zimbabwe, or if the lender becomes subject to foreign tax on the interest by reason of the legislative exemption from Zimbabwean tax. Finally, the exemption for the interest in group 3 is also withdrawn if the loan is from a foreign company to a company incorporated in Zimbabwe that is controlled, directly or indirectly, through exercisable share-voting rights, by the lender and the interest is subject to tax in a foreign country which gives double taxation relief for the Zimbabwean tax chargeable.

Securities for loans to the State, a local authority or statutory corporation are exempt from CGT.

If the lender, entitled to the gross interest of Z$ 100,000, were a U.K. company subject to U.K. tax on the interest, Art. 11(2) of the DTA would operate to reduce the total Zimbabwean tax to a maximum of 10% of the gross interest. Art. 11(2) would not operate if the lender were carrying on business in Zimbabwe through a permanent establishment with which the loan was effectively connected (Art. 11(6)). And Art. 11(2) would not apply to the excessive portion of interest paid by reason of some special relationship, e.g. associated companies (Art. 11(8)). Art. 11(5) stipulates that interest on indebtedness or credit guaranteed or insured by the U.K. Export Credits Guarantee Department is exempt from Zimbabwean taxes.

Any capital gain made by the U.K. company in respect of interest-bearing investments that did not form part of the business property of a Zimbabwean permanent establishment is exempt, by virtue of Art. 14(4), from Zimbabwean CGT. The maturity or redemption of a chargeable asset is, under Zimbabwean legislation, deemed to be a sale of the asset for CGT purposes. Accordingly, it is submitted, the maturity or redemption is to be interpreted as an "alienation" of the asset for the purposes of Art. 14(4). This follows from Article 3(2) which directs that any term not defined in the DTA shall, unless the context otherwise requires, have the meaning which it has under the law of the Contracting State. The term "alienation" is not defined in the DTA. It can only be equated with the term "sale", including deemed sales, in the law, for CGT purposes, of Zimbabwe.

4. ROYALTIES AND CAPITAL GAINS FROM ASSETS THAT CAN GIVE RISE TO ROYALTIES RECEIVED BY A FOREIGN COMPANY

	Royalties Z$	*Capital gains Z$*
Zimbabwean taxable income	100,000	--
Zimbabwean capital gain	--	100,000
Zimbabwean income tax 1985/86 rate 52.875%	52,875	--
Zimbabwean branch profits tax 1985/86 rate 8.4%	8,400	--
Zimbabwean non-residents' tax on royalties (NRTROY) current rate 20%	20,000	--
Zimbabwean relief from the levy of both income tax and NRTROY	(20,000)	--
Zimbabwean CGT 1985/86 rate 30%	--	30,000
Overall rate of tax	61.275%	30%

Royalties, including know-how payments, for the use or the right to use any patent, design, trade mark, copyright, model, plan, secret process or formula or any other property of a similar nature, or any motion picture film or television film including any sound recording or advertising matter connected therewith, are deemed to be from a source within Zimbabwe for the purposes of income tax and branch profits tax if the royalties are payable for the use or the right of use of the patent, etc., in Zimbabwe. The term "royalties" is not defined for the purposes of these taxes, but it is defined for the purposes of NRTROY. In terms of the definition it means any amount payable as a consideration for the use of, or the right to use, any literary, dramatic, musical, artistic, scientific or other work whatsoever (including cinematograph films or recordings) in which any copyright exists, any patented article, 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 equipment. It does not matter if the consideration is paid with or without permission or authority from the holder of the copyright or patent. Exemption from NRTROY can be granted by ministerial notice in the Government Gazette. There is a liability for NRTROY if the property is used in Zimbabwe or if the payer of the royalties is ordinarily resident in Zimbabwe.

The Income Tax Act allows the deduction of revenue expenditure incurred for the purpose of earning the taxable income by way of royalties, but NRTROY is levied on the gross amount of the royalties without any deductions whatsoever. If the foreign company earning the royalties was allowed to deduct, in determining its taxable income subject to income tax and branch profits tax, its foreign expenditures of a technical, managerial, administrative or consultative nature, a tax of 20% would be levied if and when such expenditure was remitted from Zimbabwe. NRTROY is levied regardless of whether the royalties are remitted from Zimbabwe or not.

Royalties in respect of mineral rights in Zimbabwe are from a source in Zimbabwe and taxable income from such royalties is accordingly subject to income tax and branch profits tax in the hands of the foreign company. But it will be noted that the definition of "royalties" for the purposes of NRTROY does not include mining royalties and they are therefore not chargeable to NRTROY.

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It was explained earlier in this article that only "specified assets" are chargeable to CGT. In the context of royalties, the only specified asset that comes to mind is immovable property.

If the foreign company, entitled to the royalties of Z$ 100,000, were a U.K. company subject to U.K. tax on the royalties, Article 12(2) of the DTA would operate to reduce the total Zimbabwean tax to a maximum of 10% of the gross royalties. Royalties are defined in Art. 12(3) and are identical to that employed for the purposes of NRTROY. Therefore Art. 12(2) does not apply to mining royalties and in terms of Art. 6, these remain subject to Zimbabwean income tax and branch profits tax with the latter being reduced, as earlier explained, from 8.4% to 2.5% and the U.K. giving double taxation relief in terms of Art. 23(1)(a). The definition of permanent establishment specifically includes a mine. Art. 12(2) would also not apply if the U.K. company derived non-mining royalties and were carrying on business in Zimbabwe through a permanent establishment with which the right or property, giving rise to the royalties, is effectively connected (Art. 12(4)). If any part of the royalties is excessive by reason of some special relationship, e.g. associated companies, the 10% restriction would not apply to the excessive portion (Art. 12(6)).

Zimbabwe retains its right to levy CGT on capital gains from the sale, or deemed sale, of immovable property in respect of gains from sources within Zimbabwe (Art. 14(1)). Double taxation relief is allowable by the U.K. in terms of Art. 23(1)(a).

In concluding this article it must be pointed out that the currency of Zimbabwe is not negotiable outside Zimbabwe and that the exportation from Zimbabwe of funds in a foreign currency is permitted only if it is made in accordance with the exchange-control regulations that are in force in Zimbabwe. Enquiries as to the regulations currently in force may be addressed to any bank in Zimbabwe.

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COLOMBIA:

Tax Reform Adopted by Congress

By James Leavy

Mr. Leavy, of Cavelier, Abogados, Bogota, is a correspondent for the *IBFD, Tax News Service* and *Corporate Taxation in Latin America* on Colombian tax matters.

After several marathon sessions Congress finally adopted, in the dying moments of its specially-extended 1986 session, the tax reform proposals presented by the Government. Although President Barco's Liberal Party has a comfortable majority in both houses of Congress, the Government had to make an immense effort to overcome indiscipline in its own party ranks which threatened to kill the reform package for lack of Congressional attention. In the end, Congress accepted the basic proposals presented by the Government but not without making many modifications to them, some of which were substantial.

Among the principal elements of the tax reform package are the following:

1. The unification of corporate tax rates: in future there will be a uniform rate of 30% applicable to all types of business entity. This rate will be phased in for "sociedades anónimas" (corporations) and similar entities over the fiscal years 1986, 1987 and 1988. Amounts saved by corporations in 1986 as a result of the new lower rates of tax must be used to finance expansion of corporate activities, to increase their capital or to purchase assets indicated by the Government.
2. The elimination in principle of the double taxation of dividends and income from shareholdings in "sociedades de responsabilidad limitada" (limited liability companies) and other types of business organizations: henceforward, the burden of taxation on income generated by business organizations will fall exclusively on the organizations themselves and not on their owners or shareholders (except in the case of foreign owners or shareholders). Owners and shareholders (other than shareholders of companies listed on the stock exchange and investors in pension or mutual investment funds) are liable for payment of the income tax of the relevant business organization in proportion to their interest in the organization. Where the distributed profits of the organization exceed 7/3 of the amount of income and capital gains tax payable by the organization, such excess is considered to be taxable income of the owners or shareholders and the organization must make provision for withholding at source of tax payable on such amounts.
3. The gradual reduction of tax deductibility for increases in interest payments and other financial costs arising from inflation. This measure will be accompanied by a corresponding gradual elimination of income and capital gains tax on the inflationary component of the increases in the value of interest and other financial income received by corporate taxpayers. In the case of interest received by individual taxpayers on bank accounts, on public debt instruments and on bonds and commercial paper issued by companies listed on the stock exchange the proposed tax relief will take complete and immediate effect as from the 1986 fiscal year.
4. The simplification of personal income tax: the tax base will be broadened by the elimination of a wide range of deductions, discounts and exemptions; the tax threshhold will be considerably raised and marginal tax rates reduced. The top marginal tax rate will be reduced from 49% to 30%.
5. The capital gains tax will in nearly all cases be assessed at the same rate as income tax; in the case of corporations and other business organizations, gains will be taxed at a rate of 30%.
6. A wide-ranging amnesty is offered to delinquent taxpayers and an attempt will be made to clear up the huge backlog of cases pending before the tax authorities. For example, any case involving sales or stamp tax which has been pending for at least 10 years will be presumed to have been determined in favour of the taxpayer.
7. The Government has been given extensive powers to reorganize the tax administration, to adopt a new tax code, to eliminate generally the taxation of inflationary components of the nominal value of taxpayers' income or capital gains and to adopt measures with a view to stimulating "sociedades anónimas", to increase the number of shareholders of such corporations and to "democratize the ownership of the means of production".
8. All peso amounts mentioned in the tax legislation will be automatically adjusted in accordance with changes in the Consumer Price Index for the 12-month period beginning on 1 October of each year.
9. Investment in Colombian corporations will not be included in the "patrimonio líquido" (roughly equivalent to net worth) for the purpose of calculating a taxpayer's "presumed income" (which is basically a percentage of his net worth). Where a

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taxpayer's presumed income is higher than his declared income, tax is calculated on presumed income.

For foreign companies and natural persons with business interests in Colombia, the following aspects of the tax reform package will be of particular interest:

1. Colombian-source income received by non-resident foreigners will, unless otherwise provided, be taxed at 30%. The Government is, however, authorized for a period of 2 years from the promulgation of Law 75 to reduce that rate so that it "harmonizes" with tax changes in countries with foreign investments in Colombia regarding tax credits available in such countries for taxes paid in Colombia.
2. Dividends received by foreign corporations from investments in Colombia will be taxed at 30% (formerly the rate varied from 20% to 40% depending on the country of origin of the corporation).
3. The basic tax rate on income, other than dividends, received by non-resident corporations will be 30%; this includes interest, commissions, royalties, fees for services and profits from branches or from business organizations other than "sociedades anónimas" (corporations).
4. The remittance tax on income from a Colombian branch operation has been raised from 20% to 30% of the net amount after payment of income tax.
5. All amounts paid to foreign companies under turnkey and construction contracts will be deemed to be Colombian-source income and will be subject to a withholding of 1% of the gross amount (this provision will only apply to contracts signed, modified or extended after the new legislation came into force).
6. The basic remittance tax rate on contracts not otherwise covered by specific provisions will be 1% of the total value of the contract and withholding will be made at the rate of 1% of the gross amounts paid or assigned under the contract (this provision will only apply to contracts signed, modified or extended after the new legislation came into force).
7. Stamp duty will henceforward be payable even on contracts signed outside Colombia if such contracts are deemed to have legal or economic effects in Colombia. The basic rate of stamp duty will be 0.5% of the amount of the contract. However, foreign debt instruments will be specifically exempt from such tax.
8. Debts owed by Colombian branches, agencies, subsidiaries or affiliates of foreign companies to such foreign companies will, for tax purposes, be considered to be part of the net worth of the respective branch, agency, subsidiary or affiliate. This will have the effect of increasing the "presumed income" of the respective branch, agency, subsidiary or affiliate.
9. The various import taxes previously in force will be replaced by a single tax of 18% on the c.i.f. value of most imports. This tax will be levied in addition to customs duties.
10. The section in prior tax legislation providing for a specific remittance tax of 12% on amounts received by foreign shareholders of limited liability companies (sociedades de responsabilidad limitada) has been repealed, but it is not clear whether the general "catch all" section providing for a remittance tax of 1% of gross amounts received by non-residents will now apply to income from limited liability companies. The tax reform legislation (Law 75 of 1986) was published in the Diario Official of 23 December 1986 and entered into force on the same date. In the coming weeks and months decrees and regulations will be issued covering detailed aspects of the tax reform package adopted by Congress.

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BARBADOS:

Income Tax Reform

An Analysis of Two Budgets in 1986

By Michael Howard

INTRODUCTION

This paper examines two different sets of budgetary measures introduced by successive Barbadian Governments in the course of the general election year 1986. The first set of budgetary proposals, referred to as the April Budget, were put forward by the Barbados Labour Party (BLP) Government just before it lost power in May 1986. The July 1986 Budget comprised the new budgetary measures of the ruling Democratic Labour Party (DLP) Government. The budgetary initiatives of the DLP Government were the most extensive tax cuts in the fiscal history of Barbados since World War II. These proposals were used as a major part of the DLP's campaign strategy to win the May 1986 general elections.

An interpretation of these budgets requires in the first place a look at the trend of previous tax reforms between 1977 and 1986. Secondly, the paper discusses briefly the philosophy of tax cuts which may have informed the two Budgets, particularly the DLP's radical tax reforms. The Budgets are discussed after a brief look at the state of the economy in 1985/86. The essay focuses principally on the possible economic implications of the budgetary reforms since it is too early to discuss the actual budget impact.

Mr. Howard holds a B.A., M.Sc. and Ph.D. (Economics) degrees from the University of the West Indies. He is presently employed at the Cave Hill Campus of the University of the West Indies (U.W.I.) as a Lecturer in the Economics Department. Formerly, he was employed at the Central Bank of Barbados as a Senior Economist (1975-1979) and at the Institute of Social and Economic Research, U.W.I., Cave Hill Campus (1979-1981) as a Research Fellow.

PREVIOUS INCOME TAX REFORMS (1977-1985)

Considerable attention was devoted to the reforms of the income tax system in Barbados between 1977 and 1986. The combined influence of inflation and steep progressivity in the income tax structure made such reforms mandatory. In 1977 a tax credit system was introduced to redistribute income to lower income taxpayers. This system continued up to 1986 when more fundamental reforms were implemented. The various modifications of the tax credit system are shown in Appendix A, Table A1.

The income tax bands were also modified between 1979 and 1985, but the structure remained steep. In fiscal 1979/80, a maximum marginal rate of 70% was charged on incomes over $ 30,000. The bands were widened in fiscal 1980/81, but high marginal rates remained on incomes over $ 30,000 (Table A2). The progressivity in the system was slightly adjusted downwards so that by fiscal 1983/84 the top rate was 60% on incomes over $ 30,000.

Table 1 also shows the annual projected cost to the revenue of income tax concessions between 1977 and 1985. These projected costs were highest in 1980 when the political directorate reduced the emphasis on income taxation and increased significantly the indirect tax burden. In that year $ 24.0 million in income tax concessions were balanced by an increase of $ 24.1 million in indirect taxes comprising mainly consumption taxes. Thereafter, discretionary income tax changes were mostly negative except for 1985, while discretionary changes in indirect taxes and levies were mostly large and positive. The latter phenomenon is primarily explained by contractionary stabilization policies between 1981 and 1985. The ratio of indirect taxes and levies to total tax revenue rose from 46.3% in 1977 to 58.6% in 1985. Personal income taxation as a ratio of total tax revenue fell from 30.1% in 1977 to 23.3% in 1985. The sharp rise in the burden of indirect taxes and levies was aided by the heavy imposition of stamp duties in 1984 (Table 1, footnote).

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Previous income tax reforms (1977-1985)
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- Property and corporation tax

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Both budgets discussed below were concerned primarily with further reductions in the income tax ratio. The author's position is that there is some justification for gradual income tax adjustments in relation to wage and price changes. Normally, the monetary benefits of such adjustments for taxpayers should be carefully weighed against their revenue costs. The Barbadian case also shows that Barbadian policy-makers, similar to policy-makers in some Caribbean territories, have adopted a high indirect tax regime. The incidence problem of indirect taxation, however, is outside the scope of this paper.

Table 1

Projected revenue impact of discretionary tax changes ($m)

Year	Income tax concessions	Indirect taxes and levies
1977	– 3.3	7.8
1978	0.6	3.1
1979	–11.4	2.4
1980	–24.0	24.1
1981	–18.7	2.8
1982	– 2.0	22.6
1983	– 2.7	24.9
1984	–14.6	30.2*
1985	8.0	28.4**

Source: Financial Statements and Budgetary Proposals for the Years 1977-1985.

* Comprises stamp duties (19.0m), consumption tax ($ 3.0 m), levies and other indirect taxes ($ 8.2 m).

** Stamp duties ($ 10.0 m), levies and other indirect taxes ($ 19.7 m).

PHILOSOPHY OF TAX CUTS

There are two basic approaches to the analysis of tax cuts. The first is the Keynesian approach which is demand side centred. The second is the supply side neo-classical approach. A broad version of the latter approach is sometimes discussed under the caption of supply side economics. This section outlines these two approaches in order to gauge the extent to which they informed Barbadian policy makers.

The Keynesian aggregative approach to the analysis of tax cuts is based on the heavy dependence on the first order income effects of a tax change.[1] A tax cut increases disposable income and the demand for output. These first order effects work their way through the economy leading to increases in investment and employment. However, the view is valid that a tax cut by itself cannot generate increases in aggregate output. Real output expansion depends on an increase in production inputs and/or more efficient use of existing factor inputs. Real output is therefore a function of a number of factors including managerial efficiency and scale economies at the micro level. These micro variables, which are crucially important in small systems, are sometimes not adequately dealt with in Keynesian aggregative analysis.

On the demand side, tax cuts in the Keynesian framework must be accompanied by a reduction in Government expenditure. This is to avoid crowding out of private sector activity. Additionally, the money supply must increase to accommodate higher levels of spending in the private sector. An expansionary monetary policy must therefore accompany across-the-board tax cuts if output increases are to be realized. The specific implications of the Keynesian approach for the open economy will be examined later for Barbados when we assume the existence of a balance of payments constraint.

The supply side approach to tax cut analysis is based on the neoclassical specification of the first order price effects of a tax change.[2] This approach is concerned with the cost of work effort vis-à-vis leisure and the price of saving relative to current consumption. Particularly, the approach posits that taxes on income decrease work effort, enterprise and saving. Reductions in personal income taxes increase the propensity to save and invest as well as work effort. Reductions in corporation taxes raise net of tax rates of return leading to re-investment in new enterprises.

Most research on the impact of supply side economics has been done in the free market U.S. economy.[3] An extreme version of supply side economics is that an across-the-board cut in tax rates would produce an increase in tax revenues. That is, work effort and savings behaviour would respond to the incentives, thereby offsetting the loss in tax revenue. As Thurow points out, supply siders believe that the free market would adjust quickly in the short run and the incentive effects would be large and positive.[4]

The Laffer curve concept is the centrepiece of supply side economics.[5] As tax rates increase, tax revenues expand but after a certain point increases in tax rates become unproductive and the revenues decline. The precise empirical point where tax rates become unproductive will vary for different economies. Although some empirical work has been done on the impact of a tax cut on labour supply in the U.S. economy,[6] there are no previous empirical studies to show the extent to which a tax cut would increase work effort, saving and investment in Barbados. Any analysis of the Barbadian case on the supply side must therefore be highly tentative.

Supply siders accept the monetarist view of the rela-

1. Our analysis in the next three paragraphs is highly indebted to Ture, N.B., "The Economic Effects of Tax Changes: A Neoclassical Analysis", in Fink, R.H. (ed.) *Supply-Side Economics: A Critical Appraisal*, Maryland, University Publications of America, 1982.
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6. Hausman, J., "Labour Supply" in Aaron, H., Pechman, J. (eds.) *How Taxes Affect Economic Behaviour*, Washington: Brookings Institution, 1981, p. 27.

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tion between inflation and the money supply in closed systems. They advocate monetary restraint to curb inflation since the latter erodes the incentive impact of a tax cut.[7] This last consideration is not as important in the Barbadian case because the money supply is endogenous and inflation is largely imported. Further, the principal impact of any monetary creation by the Central Bank is on the balance of payments rather than the price level.

Like the Keynesians, supply siders argue that reduced Government expenditure should accompany tax cuts. However, this principle relates to their view that there should be minimal Government regulation of the economy and decreased welfare spending consequent upon tax cuts. Increased incentives to individuals in the private sector are supposed to lead to less reliance on the public sector.

Two important points of reference are the so-called Thatcher and Reagan experiments which contained elements of supply side economics as well as monetarism. These experiments embraced a number of elements, two of which informed the DLP's July 1986 Budget in Barbados. These are as follows:[8]

(1) restricted rate of growth of the money supply,
(2) large across-the-board tax cuts on earnings and income,
(3) firm management of Government expenditure,
(4) less Government regulation.

Careful analysis shows that elements (2) and (3) of the Reagan and Thatcher programmes were also present in the Barbados July 1986 Budget.[9] Although the last budget proposed cuts in expenditure, it was not clear exactly what line items of current expenditure would be cut. The monetarist prescription of money supply control was absent. A major aspect of the DLP's election campaign was the discussion of privatization or disinvestment of certain public sector enterprises which can be embraced by element (4). However, no firm privatization strategy was laid out in the July 1986 Budget.[10]

It should be noted, however, that the impact of tax cuts requires both demand and supply side analysis. In this respect, more formal theoretical work than presented here would require an integration of the Keynesian and Neoclassical approaches. We now look briefly at the state of the Barbadian economy in 1985 and the first quarter of 1986.

BRIEF ANALYSIS OF THE STATE OF THE BARBADIAN ECONOMY 1985/86

Our brief review is based on data and analysis contained in the Central Bank of Barbados Annual Report, 1985 and the Economic Review, June 1986. Expansion of output in the Barbadian economy was negligible between 1984 and 1985. Real GDP grew by 0.3% in 1985 compared to 3.5% in 1984. This was due largely to declines in real output in tourism (3.0%) and manufacturing (9.3%). Tourist arrivals fell off in 1985 following a good winter season. Manufacturing output was the lowest in 10 years mainly due to the slump in the electronics components industry and protectionist measures in the Trinidad market.

The decline in real output was accompanied by high unemployment levels. Unemployment was estimated at 18.2% in December 1985. However, the rate of inflation continued low, reflecting weak consumer demand at home and low rates of inflation in industrial countries. Inflation grew at an average rate of 3.9% in 1985.

The fiscal position was characterized by an expansion of the overall deficit which rose from $ 95.8 million to $ 119.6 million (Table 2). The ratio of the overall deficit to GDP was till manageable at 5.3% for 1985. The rise in the deficit reflected increases in public sector wages and salaries as well as expanding capital expenditures.

Table 2

Selected economic indicators

	1984	1985
Balance of payments (BDS$m)		
Current account surplus	24.0	42.0
Capital account	–29.0	88.0
Errors and omissions	7.0	–37.0
Overall surplus (+)	2.0	93.0
Official financing	9.0	–7.0
Reserves (increase (–))	–11.0	–86.0
Total debt service ($m)	108.2	127.1
Debt service ratio* (%)	3.7	4.7
Total Government deficit	95.8	119.6
Overall Government deficit as % of GDP	4.6	5.3
Real GDP annual growth rate (%)	3.5	0.3
Inflation (%)	4.6	3.9
Unemployment (%)	18.3	18.2

* This is the debt service ratio for Government and Government guaranteed debt. It is the ratio of interest and amortization on foreign debt to exports of goods and services.

Source: Central Bank of Barbados, *Annual Report*, 1985.

The balance of payments was characterized by a reduction in merchandise trade, large debt payments and insignificant private capital inflows. The Central Bank reports that Government borrowed $ 88.6 million to strengthen foreign reserves and provide funds to meet amortization payments (Table 2).

7. Orzechowski, W.P., "Monetary Aspects of Supply-Side Economics," in Fink, op. cit., pp. 418-419.
8. See Thurow, op. cit. p. 129 and Burton, J., "The Thatcher Experiment: A Requiem?" in Fink, op. cit. p. 294.
9. The DLP Manifesto, 1986, which preceded the elections reported that "all ministries will be asked to identify expenditure cuts equivalent to 2% of the approved Current Estimates of Expenditure." The Manifesto stated further that "under no circumstances will there be a reduction in the services or jobs provided by Government." DLP Manifesto, General Elections, 1986, p. 6.
10. No explicit statement was made on Government disinvestment either in the DLP Manifesto or the July 1986 Budget. The Manifesto stated that the DLP would "ensure that Government-owned commercial enterprises, other than the Transport Board, cease to be a drain on the public purse". The July Budget merely pointed to the inefficiency of Government-owned commercial enterprises.

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The first quarter of 1986 showed some improvement with manufacturing output growing by 10% during the quarter. Sugar output rose to 111,150 tonnes, a 11.2% increase over 1985. Tourism arrivals grew by 4.5% in the first quarter compared to 3% in the same period in 1985.

Despite the first quarter improvement, the Central Bank's Economic Review reported that foreign reserves fell during the quarter partly because of sluggish merchandise exports and outflows of investment capital. The $ 2.0 million net foreign reserve outflow was also aided by heavy loan repayments by Government and the private sector.

In the context of the difficulties outlined above, the management of the fiscal deficit and the balance of payments has assumed a crucially important role in the Barbadian economy. Further, the blow dealt to the Barbadian export oriented private sector by the international recession increased the burden of the State in the management of the balance of payments. Although many of the problems of the Barbadian private sector stem from the nature of its integration into the international capitalist system, one can identify two institutional problems. The conservatism in management in certain areas of the domestic private sector, as well as risk-averse behaviour in external marketing are principal factors retarding the resurgence of the Barbadian private sector in relation to export promotion industrialization. This is the appropriate development strategy which should inform tax incentive policy.

THE APRIL 1986 BUDGET

The April 1986 Budget reflected a cautious attitude to tax reform. This philosophy of *fiscal gradualism* which characterized the BLP's income tax reforms since 1977 (Appendix A, Tables A1 and A2), stemmed from the fact that the Government became locked into a large capital works programme.[11] Capital expenditure for fiscal 1985/86 was originally estimated in the budget at $ 183.3 million but the actual outcome was $ 146.1 million. The overall fiscal deficit for fiscal 1985/86 was estimated at $ 155.6 million and the actual outcome was $ 125.5 million.[12] Further, heavy amortization payments absorbed foreign capital inflows and forced the Government to tap the domestic market for finance. Additionally, the Government resorted to borrowing for balance of payments purposes which totalled $ 88.6 million in 1985. The overall weakness of Government finances led to a budget which gave some income tax concessions but was not very expansionary. The more generous tax proposals of the DLP's July Budget discussed below reflected the high political opportunity cost inherent in the BLP's policy of fiscal gradualism in an election year.

The conceptual framework of the BLP's budgetary measures can be described as Musgravian since they attempted to balance the fiscal goals of allocation, income redistribution and stabilization. The political strategy of the budget was implicit in the income tax cuts designed also to stimulate private sector activity. The principal feature of these cuts (see Appendix C) was the abolition of income tax for persons earning below $ 10,000 and the reduction of the top rate of income to 50%. These reforms which reduced the progressivity of the system were an advance over the previous tax credit scheme. The criticism is valid that the first three bands of the tax scale remained relatively narrow, despite reforms at the top and the bottom.

The income tax reforms at the bottom of the scale, together with the increases in contributory and non-contributory pensions (Appendix C, item 21), constituted the redistribution measures. To a large extent, these reforms were merely a continuation of the strategy of gradual income tax reductions since 1977.

Other allocation measures included attempts to aid export sales and to retain income in the domestic economy (Appendix B, items 5, 8, 9). Although these measures will not work any miracles for the Barbadian economy, they show some appreciation of the need for foreign exchange retention. It is significant that these measures were not nullified by the July 1986 Budget.

The April Budget was criticized because it was not generous in terms of tax relief. The budget was conceived at a time when the economy was still experiencing recessionary conditions, falling reserve levels and a weak fiscal position. This budget lacked public support because the arguments for fiscal gradualism were overridden by political factors suggesting a change in Government in 1986.

THE JULY 1986 BUDGET

Rationale and popular appeal

The DLP's July 1986 Budget was undoubtedly the most popular budget in Barbados in recent times. The announcement of this budget in the election campaign proved to be a highly successful political strategy. This budget rested heavily on the view that the most important domestic cause of the depressed state of the Barbadian economy was the heavy increases in taxation by the previous BLP administration.[13] The budget was strongly expansionary and it was widely believed that the proposals would provide a fillip to increased economic activity as a result of the first order income effects of the tax cuts.

Psychologically, the budget elevated the expectations of consumers as utility maximizers. The political direc-

11. The BLP strategy, as outlined in the April 1986 Budget, placed more emphasis on the public sector as a catalyst of development. The budget opined that Barbados had not yet developed an "active enough entrepreneurial class in the private sector who are risk takers". Budgetary Proposals, 2 April 1986, *Barbados Advocate*, 3 April 1986.
12. The estimated magnitudes are found in the April Budget Speech, while the actual out-turn figures are found in Central Bank of Barbados, *Economic Review*, June 1986.
13. Budgetary Proposals presented by Finance Minister, *Barbados Advocate*, 16 July 1986, p. 6.

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torate argued that the budget deficit was manageable. Amidst almost euphoric public support, the measures still generated a number of issues relating to the costs of the tax cuts, as well as the perceived macroeconomic effects on the economy. It is appropriate first of all to identify the commendable, and less controversial, aspects of the July 1986 Budget.

Some equity and efficiency measures

A number of measures proposed in the July 1986 Budget are acceptable to the author on grounds of equity and efficiency. These are as follows:

(1) abolition of tax on pensions and severance pay,
(2) increase in pensions,
(3) reduction of the hotel and restaurant Sales Tax,
(4) reduction of stamp duties on certain goods such as medicines and building materials,
(5) abolition of T.V. licences,
(6) proposal for a graduated corporation tax,
(7) transfer of transport, health and training levies to the consolidated fund.

The abolition of tax on pensions and severance pay, as well as increases in old age pensions are justified on grounds of equity. In high unemployment societies, taxes on severance pay are inequitable. Like unemployment insurance, severance pay should be regarded as an allowance to compensate for the risk of unemployment.

Reductions in indirect taxes and charges (items 3 to 5) are justifiable on the basis of efficiency and equity considerations. The lowering of hotel sales taxes should be regarded as a measure to increase price competitiveness in tourism, thereby lowering the degree of excess burden to the consumers. The costs of collecting T.V. licences reduced considerably the contribution of this tax which was characterized by massive tax evasion. Further, stamp duties have a generally regressive incidence particularly on essentials such as medicines.

The implementation of the extra-budgetary funds such as the transport, health and training levy funds introduced a measure of earmarking into the Barbadian fiscal system. Earmarking is based on the benefit principle of taxation but can lead to some rigidity in the use of public funds. It is hoped that the transfer of these funds to the consolidated fund would encourage greater flexibility into budgetary management.

This paper accepts in principle the proposal for a graduated corporation tax. The rationale and some shortcomings of such a system are discussed later when we examine the corporation tax reforms.

Effective income tax rates

The most important feature of the DLP's July 1986 Budget was the basic allowance of $ 15,000 (see Appendix B, item 11). This allowance significantly lowered the effective income tax rate defined as the ratio of tax payable to gross annual income. However, the allowance by itself does not distinguish between taxpayers on the basis of financial responsibilities. The increase in other allowances was designed primarily to benefit the middle and upper classes who presumably save more, although sections of these classes have a tendency for conspicuous consumption. We compared the effective income tax rate for a Jamaican married person under certain assumptions,[14] with that of a Barbadian married person, assuming the basic $ 15,000 allowance.

Table 3 shows that the effective income tax rate for the Barbadian taxpayer is a low 8% compared with 29% for a Jamaican married person in 1986. The effective income tax rate for the same Barbadian taxpayer would have been 15% on the basis of the 1985 tax structure.

Further analysis shows that the maximum effective income tax rate for Barbadians, on the basis of the July 1986 tax structure, rises from a low of zero on a gross annual income of $ 15,000 to 22.3% on $ 55,000 annual income (Table 4). These rates are even much

Table 3

Effective tax rate for married person (Barbados) assuming basic $ 15,000 allowance (1986)

Gross annual income	$ 25,000
Minus minimum allowance	$ 15,000
Taxable income	$ 10,000
Tax payable ($ 10,000 x 20%)	$ 2,000
Effective tax rate ($ 2,000 ÷ $ 25,000)	8%
Jamaican effective tax rate*	29%

Source: The Editors, "Personal Tax: Jamaica and the Caribbean," *Caribbean Finance and Management* Vol. 1, Winter 1985, No. 2.

Table 4

Maximum effective tax rates for single person or married person filing separately (1986)

Gross annual income ($)	Maximum effective tax rate (%)
15,000	0.0
25,000	8.0
35,000	12.9
45,000	17.7
55,000	22.3

Source: Calculated from tax tables, Budgetary Proposals July 1986, Barbados. The basic $ 15,000 allowance was employed.

14. See the Editors "Personal Income Tax: Jamaica and the Caribbean", *Caribbean Finance and Management*, Vol. 1, Winter 1985, No. 2. This article calculated the income tax payable by a married person for Jamaica, under its new income tax system, effective January 1986. It was assumed that the taxpayer earns U.S. $ 12,500, lives in a rented house, pays 5% of his salary for pension or life insurance, has no savings and one child is under 12 years, the other over 12. To avoid complication, we compared this model taxpayer with a Barbadian benefiting from the minimum allowance of $ 15,000.

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lower than the Jamaican example. Actual effective rates are even lower for individuals claiming allowances in excess of $ 15,000. For example, we calculated the effective tax rate for an individual taxpayer earning a gross $ 55,000 annually with total allowances of $ 17,500. The effective rate was 20.2%.

Revenue costs and expenditure cuts

The relatively low effective tax rates implied a heavy cost to the fiscal revenue.[15] The July Budget proposed that the revenue costs would be offset by a $ 14.0 million cut in current expenditure, and cuts in capital expenditure effected by a rescheduling of the capital works programme. As mentioned above, it was not clear what line items of expenditure would be affected.

The view is presented here that although it is desirable to curb the rate of growth of current expenditure, it is not always easy to achieve an absolute cut over a fiscal year. There has been a tendency in Barbados to overestimate current expenditure significantly and underestimate revenue, so that Government saving is sometimes much larger than projected. However, the recurrent costs of welfare services and salaries create a built-in-tendency for expenditures to rise. An expenditure outcome below estimated levels may not necessarily indicate a genuine expenditure cut. The British Green Paper, which accompanied Thatcher's 1984 radical tax reform budget, recognized this built-in-tendency for expenditure to rise, and the resistance to expenditure reductions.[16]

Further, in the event that the Government fails to realize a genuine overall expenditure cut of $ 53 million (DLP Manifesto, p. 6), the deficit should be financed by further borrowing from commercial banks, the non-bank public or new indirect taxation. This financing strategy will be necessary if the incentive effects of the income tax cuts are not large and positive in the short run. The use of Central Bank money creation resulting from fiscal revenue insufficiency can create balance of payments problems. Commercial bank borrowing and borrowing from the non-bank public constitute a more prudent financing strategy since the resource transfer will ease the pressure on the balance of payments.

Macro-economic implications

The magnitude of the macro-economic effects of massive tax cuts, expecially output and employment effects, is theoretically indeterminate in an economy as highly open as Barbados. Again, no empirical evidence exists to inform policy-makers of the precise height of a tax cut needed to generate a predetermined level of output and employment in a highly open system.

The magnitude of employment, output and balance of payments effects also depends crucially on the preferences of the public. Part of the increased disposable income will be saved in the form of deposits and contractual savings, thereby augmenting the liquidity levels of banks and non-banks. Development, however, depends on the socially efficient use of these funds in productive sectors of the economy at appropriate rates of interest. The public should also be encouraged to invest in long-term securities.

Debt liquidation is another possible use of funds. It is possible that indigenous businesses and individuals may choose to use increased cash inflows to liquidate debts acquired during the recessionary period 1981-1985. Some of the proposals especially towards the hotel sector, may have been designed to achieve this objective. It is now appropriate to discuss critically the private sector strategy of the Government before looking at the theoretical implications of tax cuts for the balance of payments.

The July 1986 Budget placed considerable emphasis on the private sector as the principal catalyst of development. It is true that the incentive-aided foreign private sector has contributed significantly in the past to Barbadian economic development. However, the budgetary strategy differed from previous budgets in that it assumed that the free market mechanism would allocate resources more efficiently. Nevertheless, the frequent external shocks to the small Barbadian private sector, particularly the First Oil Shock (1973) and the Second Oil Shock (1981/82) showed the lack of resilience of both the foreign and domestic private sector. In the economic scenario since 1973, the State has been called upon to shoulder a larger part of the burden of providing direct employment in highly vulnerable open economies.[17] The free market mechanism strategy should not be over-emphasized in small systems subject to the vagaries of international capitalism.

Generally speaking, a broad based tax cut will normally have a mild stimulative effect on a small economy. However, a personal income tax cut cannot assist firms geared to export markets. Employment and output levels generated by foreign-owned enclave industries depend on world market conditions. The sugar industry is assisted by a special subsidy and the performance of tourism is determined by a wide variety of factors including per capita incomes and economic conditions in tourism markets.

A personal income tax cut may aid domestic manufactures by raising the demand for import substitutes. Although some degree of import substitution is important, especially in food production, this industrial process cannot be relied upon to sustain a long-term development effort. The import substitution process requires high protection levels thereby fostering inefficiency. Additionally, the process is limited by the size

15. The DLP's proposals were costed by the BLP Minister of Finance at $ 109 million. The same proposals were costed by the DLP Minister of Finance at $ 67 million.
16. For useful comments on the British Green Paper (CMnd 9189, HMSO) see H.M. Treasury, *Economic Progress Report,* No. 166, March/April, 1984.
17. This author has made this point elsewhere. See M. Howard, "How We Can Avoid Devaluing," *Barbados Advocate,* 21 January 1986.

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of the market and the lack of scale economies by small indigenous manufacturers in Barbados.[18]

In a small, open economy the balance of payments is the principal constraint on fiscal expansion. The constraint operates in two ways. When Government pursues an expansionary expenditure policy, the extent of foreign reserve loss is determined in large measure by the degree of domestic credit expansion, particularly Central Bank money creation. This instrument of financing requires no resource transfer from the rest of the economy and the reserve loss may be significant.

On the other hand, when Government pursues an expansionary fiscal policy by way of massive tax cuts, the onus of new investment expansion is placed on the private sector, even though Government still pursues its capital works programme. The degree to which the domestic investment effort can be sustained is determined by the availability of foreign exchange. This is so because domestic savings must be supplemented by foreign exchange to finance imports. Domestic investment in the aggregate is equal to domestic saving plus the deficit in the balance of payments which must be financed by foreign borrowing.[19] This Kennedy proposition implies that the balance of payments is a binding constraint on development in small, open systems.

Direct expenditure by the public will have an indeterminate revenue feedback effect in terms of increases in indirect tax collections. If people spend too much money on consumption, Government will have to resort to new indirect taxation. However, quantitative restrictions on imports create distortions in commodity markets. They should also be avoided since they run counter to the private sector philosophy of the Government.

Property and corporation tax

The reduction of hotel property tax rates by 50% will significantly benefit foreign as well as locally owned hotels. This measure cheapens considerably the cost of foreign ownership of land in Barbados. This measure was probably implemented to ease debt problems in the hotel industry, since the proposal cannot lure tourists to Barbados anymore. Some thought should be given to the upward revision of hotel property tax rates in the 1987 Budget.

The corporation income tax (CIT) was reduced from 45% to 35% in the July Budget leading to a revenue loss of $ 12 million. A reduction of the top rate of CIT to the pre-1976 level of 40% would have been more reasonable to stem the heavy revenue loss and contain the fiscal deficit. The Barbadian case is similar to the British precedent established in Thatcher's 1984 Budget. This budget reduced the British CIT from 50% in 1984, to 45% (1985), 40% (1986) and 35% (1987). Smaller companies were subject to a reduced rate of CIT.[20] In the Barbadian case, a 10% fall in the rate in one year was much too steep.

The purpose of CIT reduction is to induce profitable companies to re-invest their surpluses or to encourage a flow of new capital into the corporate sector. According to W.A. Lewis,[21] a rising share of the capitalist surplus makes for development depending on the orientation of the capitalist class. A buoyant industrial capitalist class, which is willing to take risks and re-invest its profits, favours capitalist development. Profit-financed capital formation is more rapid, the larger the industrial capitalist class. In the Barbadian context, the capitalist class comprises mainly foreign investors, small indigenous businesses and manufacturers, as well as the traditional indigenous planter and commercial classes. Reductions in the CIT will have more benefits for the commercial companies. It is hoped that this group will not use its surpluses for conspicuous consumption, but will contribute more to the development of a capital market by broadening its issue of share capital.

The proposal of the July Budget for a graduated corporation tax, effective from income year 1987, must be examined carefully against its revenue costs. Graduated income tax rates are designed to offer relief to small businesses by graduating the rate according to size of profits. However, Lent and Goode have pointed out that graduated company rates provide the opportunity for avoidance of income tax through multiple incorporation.[22] That is, rather than operate a single business, a firm may find it more convenient to incorporate separate branches each of which enjoys the benefit of lower rates. This problem can be tackled by requiring controlled companies to file consolidated returns. Initially, a two-tiered system should be tried to distinguish between small and large resident corporations rather than a multiplicity of rates.

CONCLUSION

The April 1986 Budget of the BLP Government reflected an approach to income tax reform which can be described as fiscal gradualism. This approach was initiated around 1977 and culminated in the moderate tax cuts of 1986. The April Budget was only part of a much broader political strategy to retain power in May 1986. It was overshadowed by the more generous proposals of the July Budget.

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18. This paragraph develops a point made by Howard, M., "A Good St. John Budget", *Barbados Advocate,* 11 April 1986. See also Owen Arthur, "Opposition's Reply to Budget", *Barbados Advocate,* 23 July 1986.
19. The foreign exchange constraint in open economies has been discussed by Kennedy, C., "Keynesian Theory in an Open Economy", *Social and Economic Studies,* March 1968. Kennedy posited that the output of an open developing economy was capable of expansion in response to increased demand, provided the necessary increase in imports could be financed. The balance of payments was the key to growth and development. See also remarks by Owen Arthur, "Opposition's Reply to Budget", *Barbados Advocate,* 23 July 1986.
20. Prest, A. R. and Coppock, D.J. (eds.), *The U.K. Economy,* London: Weidenfeld and Nicolson, 10th Edition, 1984, p. 110. See also H.M. Treasury, *Economic Progress Report,* op. cit., p. 5.
21. Lewis, W.A., "Economic Development With Unlimited Supplies of Labour in Agarwala, A.N. and Singh, S.P. (eds.), *The Economics of Underdevelopment,* London: Oxford University Press, 1958, p. 429.
22. Lent, G., "Corporation Income Tax Structure" in Developing Countries, *IMF Staff Papers,* Vol. XXIV, No. 3, November 1977, p. 737. Also Goode, R., Government Finance in Developing Countries, Washington: The Brookings Institution, 1984, p. 112.

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The tax cut proposals of the July Budget embraced uncritically the conservative philosophy of free market capitalism. Unlike the BLP's budget, the DLP's tax reforms constituted the core of a highly successful political strategy. The private sector was conceived as the principal catalyst of development whose momentum was arrested by the BLP's burdensome tax policy as perceived by the DLP.

The July Budget, though hailed as a major political victory, was implemented at a high cost in terms of fiscal revenue foregone. It was hoped that the budget would restimulate the economy, thereby recapturing part of this revenue. This analysis was based on the view that the economy would adjust on the supply side, and the multiplier effects would be large and positive. Although it is much too early to examine the effects of the July Budget, such theoretical optimism should be tempered by the view that the economy faces a balance of payments constraint and the dynamic of major productive sectors is determined by world market conditions. The economy also faces the prospect of a wider fiscal deficit as a result of the wide-ranging tax reforms of the July Budget.

Part of the analysis of this paper reflects the politics of economics. Many Government budgets are designed to maximize votes. According to Wagner and Buchanan, "it is the expectation of political gains and losses from alternative taxing and spending programmes which shapes the budgetary outcomes that emerge within a democratic system of political competition".[23]

The author believes there is substantial merit in the philosophy of fiscal gradualism in income tax reform in developing countries. First, there is a high degree of indeterminacy in the relation between massive tax cuts, output and employment generation in developing countries. Second, fiscal revenue insufficiency in small, developing countries very often leads to excessive borrowing to finance fiscal deficits.

23. Wager, R. E. and Buchanan, J.M., "Democracy and Keynesian Constitutions: Political Biases and Economic Consequences", in Buchanan, J., Wagner, R.E. and Burton, J. (eds.), *The Consequences of Mr. Keynes*, London: The Institute of Economic Affairs, 1978.

APPENDIX A

Table A1

Tax credit system

Year

1977 – Introduction of a tax credit of $ 60 for all resident taxpayers with gross income of less than $ 6,000 per year to apply to income year 1976.

1979 – Increase in tax credit to persons with gross income of less than $ 6,000 per annum from $ 60 to $ 100 for income year 1979.

1980 – Increase in tax credit from $ 100 to $ 300 for persons with gross income of $ 6,000 or less and grant of credit of $ 100 to persons with incomes in excess of $ 6,000, but less than $ 8,000.

1981 – Increase in tax credit from $ 300 to $ 360 for persons earning a gross income of $ 6,000 or less. Introduction of a tax credit of $ 240 for persons with incomes in excess of $ 6,000 but less than $ 7,000. Increase in tax credit to $ 120 for persons with gross incomes in excess of $ 7,000 but less than $ 8,000.

1984 – Increase in tax credit from $ 360 in lowest category to $ 400. The limit of the lowest category was raised from $ 6,000 to $ 7,500. Increase in the tax credit to $ 250 for persons earning less than $ 8,500 per annum but more than $ 7,500 per annum. This meant the abolition of income tax for persons earning less than $ 145 per week.

Note: The tax credit system was designed to reduce tax payable for the lowest income groups. For example, a taxpayer of $ 6,000 per year or less, whose net tax due was less than $ 60, was not required under the tax credit system to pay income tax.

Source: Barbados: *Financial Statements and Budgetary Proposals for the years 1977, 1979, 1980, 1981 and 1984.*

Table A2

Income tax structures

Rate structure fiscal 1979/80		Rate structure fiscal 1980/81		Rate structure fiscal 1983/84	
Taxable income $	Rate %	Taxable income $	Rate %	Taxable income $	Rate %
Up to 3,000	10	Up to 5,000	10	Up to 5,000	10
6,000	20	10,000	20	10,000	20
8,000	30	15,000	30	15,000	30
10,000	35	20,000	40	20,000	40
12,000	40	30,000	50	30,000	50
16,000	50	40,000	60	Over 30,000	60
30,000	60	40,000	70		
Over 30,000	70	Over 40,000			

Source: Barbados: Financial and Budgetary Proposals for Years 1979, 1980, 1983.

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APPENDIX B

Major budgetary measures: April 1986 Budget

Income tax

1. No income tax payable on total assessable annual income of $ 10,000 or less.

2. The 1985/86 income tax rate structure was as follows:

Taxable income $	*Rate %*
Up to 5,000	10
10,000	20
15,000	30
20,000	40
30,000	50
Over 30,000	60

It was proposed that the 1986/87 schedule should be as follows:

Taxable income $	*Rate %*
Up to 6,000	10
11,000	20
18,000	30
30,000	40
Over 30,000	50

3. Mortgage interest allowance increased from $ 9,000 annually to $ 12,000.

4. Allowance for employing a gardener/household help increased from $ 500 annually to $ 1,200.

Export expansion

5. Extension to the tourist industry of market development allowance introduced in income year 1985 to aid export sales in extra-regional locations.

Depreciation allowance

6. Increase by 1% the annual depreciation allowance for certain categories of commercial building.

Building allowance

7. A building allowance at the rate of 10% of the assessed value of the property to be extended annually in respect of listed properties of a commercial nature.

Investment income

8. Investment income retained in Barbados by enclave enterprises owned by non-nationals will be taxed as income from exports.

9. A 50% tax credit of the net foreign currency earnings from qualifying overseas construction projects as well as qualifying overseas professional services which have been remitted through the Barbados banking system.

Property tax

10. A rate of 0.4% up to $ 500,000, plus 0.7% of any excess up to $ 1.0 million, plus 1.0% of any excess over $ 1.0 million.

Consumption tax

11. Reduction from 15% to 0% of the consumption tax on musical instruments. Removal of 10% consumption tax on microwave ovens used for domestic purposes.

Pensions

12. Contributory national insurance pensions and related benefits increased from $ 50 per week to $ 60. Increase in non-contributory old age pensions from $ 40 per week to $ 48 per week.

13. Small reduction in price of petroleum products.

14.

Concessions	*$ million*
Personal income tax	12.1
Corporation tax	2.4
Land tax	1.9
Licensing fees	0.3
Consumption tax	0.4
Welfare grants	2.3
Pensions	0.2
Reduced petroleum prices	7.4
Total	27.0
National insurance pensions	13.6
Increased revenue	
Consumption tax on petroleum products	15.0

Source: Barbados: Financial and Budgetary Proposals, April 1986.

APPENDIX C

Major budgetary measures: July 1986 Budget

Income tax

1. No income tax payable on total assessable annual income of $ 15,000 or less.

2. Maximum income tax rate of 50% with the new bands and rates on taxable incomes as follows in Barbadian dollars:

Up to $ 15,000	– 20%
$ 15,001 to $ 25,000	– 30%
$ 25,001 to $ 35,000	– 40%
$ 35,001 to $ 55,000	– 45%
Over $ 55,000	– 50%

3. Family allowances increased by a minimum of 50%.

4. Allowances in respect of housekeepers/household helpers/gardeners increased from $ 500 to $ 1,200.

5. Full mortgage interest allowed as deduction from assessable income.

6. 50% of insurance premiums allowable as a deductible expense in respect of owner-occupied homes.

7. Full cost of repairs allowed as a deductible expense for owner-occupied houses.

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8. Medical expense allowance increased by 50%.
9. With effect from income year 1986, all pensions will be exempted from income tax.
10. Effective income year 1986, no income tax will be payable on severance payments.

Basic allowance of $ 15,000

11. In addition to the proposal that persons whose total annual assessable income is $ 15,000 or less will pay no income tax, it was proposed that persons whose total annual income is greater than $ 15,000, and whose allowances and deductions do not amount to $ 15,000, will be allowed to claim $ 15,000 in allowances and deductions. Those persons whose allowances and deductions exceed $ 15,000 will be allowed the full amount of those allowances and deductions.

    It was estimated that in fiscal year 1986/87 the gross revenue loss from the above changes would amount to $ 49.0 million.

Corporation tax

12. Maximum rate of corporation tax reduced from 45% to 35%, effective from income year 1986. The revenue loss from this proposal was estimated to be $ 12.44 million.
13. A graduated corporation tax ranging from 15% to 35% being examined for implementation for income year 1987.

Property tax

14. Land taxes payable by hotels and apartment hotels will be reduced by 50%.
15. Effective from 1 April 1987, persons living in their own houses will pay land tax on 70% of the improved value of their properties.
16. Pensioners living in their own homes will be granted a reduction of 50% of the tax payable on the improved value of their property effective from 1 April 1987.

Indirect tax

17. Reduction by 50% of taxes and fees payable on public service vehicles effective from 1 January 1987.
18. The hotel and restaurants sales tax will be reduced from 8% to 5%, effective from 15 December 1986.
19. Abolition of T.V. licences.
20. Reduction of stamp duty on wines and certain basic building materials and foods from 12% to 10%.
21.

Pensions	*Present*	*Proposed*
Non-contributory old age pension	$ 48.00 per wk.	$ 50.00 per wk.
Old age contributory pension	$ 60.00 per wk.	$ 62.00 per wk.
Invalidity pension	$ 60.00 per wk.	$ 62.00 per wk.

Agricultural incentives

22. Effective 1 April 1986, the agricultural levy will be abolished and the payments made since its introduction will be refunded.

Other reforms

23. Moneys from extra-budgetary funds such as the Transport Levy Fund, Health Levy Fund and Training Levy Fund to be transferred into the Consolidated Fund.
24. List of allowances

	$
Personal allowances	
Single	4,500
Married	7,500
Child allowance	
Under 18	750
11-16 educated in Barbados	900
16-25 educated in Barbados	1,200
16-18 educated abroad	1,200
18-25 educated abroad	2,100
Dependent relatives	750
Household help	1,200
Gardener	1,200
Housekeeper	1,200
School fees (children over 11)	525
Medical expenses	
Married	450
Other cases	225
Each child	120

Source: Budgetary Proposals Presented by Finance Minister, 15 May 1986, Published in *Barbados Advocate*, 16 May 1986.

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The Weak Case for Dualistic (Composite) Types of Income Taxation

By Sylvain R.F. Plasschaert

I. INTRODUCTION

Pure schedular income tax systems are very rare today.[1] Even in earlier times, they generally were "roofed over" by a "complementary tax" on total (global) income (hereafter designated as "surtax"). It is worthwhile to note that sometimes – as in Italy in 1925 and in Egypt in 1949 – the surtax was added to a pre-existing set of schedular taxes. Particular attention must be given to France, where, after many vicissitudes, a new income tax system was approved in 1917 by Parliament which introduced 7 schedular taxes and a surtax on total individual income. Such systems can be called "dualistic" or "composite".[2]

The dualistic or composite system consists of two superimposed layers, predicated on a different philosophy and displaying a different morphology. Hence, each layer of this system should incorporate its inherent structural features of tax design. Thus, a schedular tax system has an object-centered character and personal exemptions and allowances for family dependents do not fit into such a system. Such a system would impose flat rates, differentiated over the various schedules, with income from capital being taxed more heavily than that from labour. Only income originating within the country would be taxable. The tax on business income would apply to all types of juridical persons (such as companies) and to individuals, to commercial and industrial enterprises and perhaps even to agricultural units, as well.

In contrast, the base of the surtax consists of the aggregation of all incomes, whatever their nature and geographical origin, that accrue to individuals (or, more frequently, to households, when the latter are considered to be the statutory taxpayer). Companies are *not* liable to the surtax. The tax is "personalized", in that it aims at apportioning tax burdens according to relative taxable capacity; hence, personal exemptions and allowances for family members are deductible from taxable gross income. The taxpayer may also be eligible for some other deductions (e.g. for excessive medical expenditures), which reduce his disposable income.

It follows that there is no need to analyse here the design aspects of the dualistic system proper, as each of the two layers of the dualistic structure retains its own architectural style.[3] Actual tax systems, however, may substantially diverge from theoretical prototypes.

In this article, attention is focused on tax policy considerations. For instance, can the dualistic pattern of income taxation be viewed as an appropriate framework which is superior to the (pure) schedular one? Or even perhaps to the global-type of income taxation? Such queries must primarily be raised as regards developing countries, where dualistic systems still exist. The fact that, in recent years, a growing number of countries in the southern part of Europe, in South America and even in French-speaking Africa[4] have substituted their dualistic system by a global-type tax system, must thereby be taken into account.

Surprisingly little research has been devoted to the analysis of the normative dimensions of the dualistic system, i.e. its qualities and drawbacks; even the modes of operation of the system have been neglected. This is the case even for prominent representatives of the older tax scholars, such as *H. Laufenburger*, *L. Einaudi*, *P.J.A. Adriani*, *F. Neumark* with the possible exception of *A. de Viti de Marco*[5] – although they have given a detailed analysis of the framework of the schedular and global tax systems.

In Section 2 we will examine the justification which has been advanced in favour of the dualistic model and we will demonstrate its weakness. To do this, we must primarily go back to the income tax reform in France in the beginning of this century. The French dualistic system has shaped not only those of France's former colonies, but has also exerted a strong influence in many Latin American countries and in Belgium.

Thereafter, we will investigate the (weak) merits and (major) drawbacks of the dualistic model in terms of a number of generally accepted canons of taxation, i.e. revenue productivity (in Section 3), the impact on income distribution (Section 4) and simplicity (Section 5). In evaluating the dualistic model, we compare it with the (pure) global one.

It is, indeed, generally accepted by tax scholars that the global approach is to be preferred over a pure

1. Zaïre, Ruanda, Burkina, Burundi, the Sudan and Hong Kong are the only countries which possess a schedular system.
2. In our view the terms "dualistic" and "composite" are to be preferred to "mixed", as the latter word connotes the intermingling, and not the superimposition, of the two types of income taxation.
3. Such tax design implications were analyzed by this author in a series of articles in the *Bulletin for International Fiscal Documentation* (BIFD). They related respectively to the definition of gross income (31 BIFD 12 (1977) at 535), the definition of net income (32 BIFD 5 (1978) at 201), the treatment of enterprise profits (35 BIFD 6 (1981) at 261), international aspects (35 BIFD 8-9 (1981) at 409) and the treatment of spouses' incomes (39 BIFD 7 (1985) at 301).
4. Thus, Belgium (1963), Italy (1925), Spain (1978), Greece (1955), Brazil (1965), Venezuela (1966), Peru (1968), (Bolivia (1975), Gabon (1981) and Morocco (1987).
5. See the bibliography following this article.

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schedular model. This has also been confirmed by previous contributions to that subject-matter, in this *Bulletin*. (See Footnote 3.)

Some examples will be drawn from existing or from now extinct dualistic income tax systems. The rather haphazard relative tax burdens which result from a dualistic system will be exemplified by reference, in the table presented below, to the present income tax system in Senegal. (In 1976, a tax reform introduced technical features in the schedular tax that are more consonant with what a rational schedular set-up would postulate.)

II. THE RATIONALE FOR THE DUALISTIC SYSTEM

France was the pioneer in the field of dualistic tax systems and it introduced such a system in 1917 during the first World War. The rationale given can be found in the writings and speeches of *J. Caillaux*, the main architect of the reforms[6] and of other French fiscal scholars of that period. The intellectual support for such reform, however, is contained in surprisingly short passages of those texts.

In his "Mémoires"[7] Footnote 7, *Caillaux* wrote: "political and equity considerations advocated a tax on aggregate income, which would complement the taxes on incomes". In fact, he confessed that he had had initially no clear idea about the format of the reform. The preface to his ill-fated reform draft contains interesting arguments for the proposed dualistic system. While the British "income tax" model had much to commend itself, its tax burden distribution was not sufficiently and openly progressive.[8]

The German system of income taxation was rejected offhand, more in light of political opportunism than of convincing theoretical arguments; it could, in the words of Caillaux, suit a docile population, as the Germans, but not the French. This statement, in essence, stems from the (appropriate) identification of a global tax with one in which the taxpayer is requested to submit an annual declaration, specifying all his income and in which the fisc possesses extensive powers of investigation. The implication was that, in a schedular system and even in a dualistic one, the formal obligations, imposed on the taxpayers, would be much less stringent and more tolerable.

Caillaux then veered to a dualistic construction. "The ideal solution would consist in combining the two systems, I considered, and in adapting them to the circumstances of life in our country"[9]. One technical argument, submitted by *Caillaux*, was that the global system in Germany did not discriminate amongst different sources of income. The "qualitative discrimination" theory was thereby apparently upheld as an important standard of tax burden distribution, alongside with that of "taxable capacity" as embodied in a progressive rate structure.

E. Allix, an influential public finance specialist, wrote in 1921 that it would be a mistake to view schedular taxes and the global surtax as opposites, "as they are, in fact, made to complement each other"[10].

All in all, the justification of the dualistic approach is weak. There has been no critical assessment as to whether the combination of the two types of taxes would provide a better result than either the global or the schedular system alone could secure. The optimistic hypothesis that the shortcomings of one layer of the dualistic model would be offset by the virtues of the other tier, has not been validated. As discussed in the next sections, such a result could not possibly have been anticipated, if one had taken the trouble to examine more closely how the dualistic system was bound to operate.

III. THE LOW REVENUE PRODUCTIVITY OF THE SURTAX

When one looks at actual dualistic income systems, one notices that the surtax only accounts for a minor share of income tax revenue. Thus, in France, Italy and Belgium, in 1960, the surtax represented no more than 2%, 18% and 10% respectively of the yield from income taxation.[11] A look at current dualistic systems in developing countries shows, on the whole, that sometimes a slightly higher proportion of income tax yield is derived from the surtax. That percentage stood at 17% in Togo (1984), at 27% in Ivory Coast (1980), but only at 8% in Cameroon (1984). In Senegal, the surtax yielded 24% of income tax revenue (1982)[12].

This low productivity of the surtax results primarily from two of its basic characteristics, namely (a) its limited taxpayer coverage and (b) the competition between the surtax and the set of schedular taxes for the same revenue potential. The deductibility of schedular tax liabilities from the base of the surtax and the narrowing of the taxable base on account of personalizing devices (another characteristic feature of global-type tax systems), also reduce the revenue potential of the surtax.

Restricted coverage – In actual dualistic systems the "cut-off" threshold for the surtax is established at a

6. The reform proposal which he submitted in 1907 was passed in 1909 by the Chamber of Representatives, but got stalled in the Senate. Only in 1917 was the dualistic income tax finally voted by Parliament, under one of *Caillaux's* successors.
7. J. Caillaux, "Mes Mémoires", Vol. I, (Paris, 1942) at 253.
8. The British standard tax was built upon schedular techniques; however, the application of a single (flat) rate and some personalizing deductions, in fact, turned the standard tax into a moderately-progressive one. In 1909, a supertax on higher level income with openly graduated rates decisively reinforced the progressivity of the British income tax.
9. J. Caillaux, "Exposé des motifs", Documents parlementaires, Session ordinaire de 1907, (Annexe No. 737) at 9.
10. E. Allix, *Traité élémentaire de science des finances et de législation financière française*, 4th ed., (Paris, 1921) at 435.
11. Based on previous research by the author, pertaining to European countries. See S. Plasschaert, *Cedulaire, globale en gemengde types van inkomstenbelastingen*, (Leuven, 1964).
12. Data drawn from the *Government Finance Statistics Yearbook*, 19 Volume IX, (International Monetary Fund, 1985).

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relatively high level of income. Hence, the number of taxpayers liable to the surtax is rather limited.

Admittedly, within a dualistic scheme, the "lesser" role of the surtax is intentional, as suggested by the name "complementary tax", with which the surtax is most often designated. In developing countries, such limited coverage is plainly justified, in terms of both equity and administrative considerations.[13] Even then, a global-type tax would appear preferable to a dualistic one, on account of the distortions and complications which are inherent to the dualistic system (see below), provided that a reasonably high degree of administrative effectiveness can be secured as regards those taxpayers who operate in the modern sectors of the economy and who would be subject to such a global income tax.

The same conclusion applies even more forcefully to high-income countries. Here, equity considerations do not counsel against the application of a global and progressive tax on the majority of income recipients whose income is well above subsistence level. Besides, the use of the withholding technique, as an instalment payment on wages and capital incomes, greatly facilitates the huge administrative task involved.

Schedular taxes and the surtax compete for the same revenue. The schedular and surtax tax liabilities are combined and not consolidated. The schedular taxes do not operate as an instalment on the surtax liability. The two tiers of the dualistic system, in laying claim to the same taxable income, are bound to compete for the same revenue. Hence, when the legislature fixes the progressive rate schedule of the surtax, it must take into account the burden already imposed by the set of schedular taxes.

The deductibility of schedular taxes. The deductibility of schedular taxes from the base of the surtax is a typical feature of dualistic models. In terms of tax principles, such deductibility of schedular income taxes cannot be defended[14]. As a matter of fact, the payment of direct taxes is not a cost of producing income, but a contribution towards the covering of public expenditure. This feature amounts to a partial, but very incomplete integration of the tax burdens of the two layers[15]. It also results in certain distortions and even irregularities in the tax burden distribution, caused by, in fact, the surtax itself – as will be shown below.

Other deductions in the surtax. Other deductions are also typically granted for surtax purposes and narrow the taxable base accordingly. As in any global tax, personal allowances are granted to the taxpayer and his dependents. In addition, other expenses that cannot easily be traced to a single source of income, such as interest payments, life insurance premiums or charitable contributions, may also be deductible. Such deductions, while they reduce the revenue potential of the surtax are compatible with the theory of a global surtax, as they aim at calibrating tax burdens according to the capacity-to-pay standard. One must add, however, that often, in respect of schedular taxes in practice, deductions and similar "personalizing" provisions erode potential revenues.

IV. HAPHAZARD DISTRIBUTION OF TAX BURDENS

The avowed purpose of the dualistic approach consists in implementing both the "qualitative discrimination" and the "ability-to-pay" principles in the schedular "ground floor" and the global "upper-floor", respectively. As discussed elsewhere[16] and as generally accepted, the "qualitative discrimination" doctrine cannot be upheld in today's economic and social world, not even in developing countries. It follows that the interpersonal income tax burden distribution inherent to pure schedular systems cannot be retained as an acceptable equity criterion. We must therefore concentrate upon whether, under otherwise equal circumstances, the dualistic approach achieves a higher degree of equity than a global one.

Let us now examine the view of *Caillaux* i.e. that not only the ability-to-pay principle but also the qualitative discrimination doctrine deserves to be implemented. When, however, one looks at the actual functioning of dualistic systems, the resulting vertical and horizontal distribution of the income tax burden does not correspond to a neat equity standard and is rather haphazard. This is illustrated in the Table below, by reference to the 1984 Senegalese income tax system. Ten well-to-do taxpayers, each of them receiving an aggregate taxable income of 3 million F.CFA, are shown and five categories of income are distinguished. As regards taxpayers A to E, all income is derived from a single source; taxpayers F and G obtain income, for equal amounts, from two sources. The last three cases portray taxpayers whose income is derived both from a main and from a subsidiary source. The table reflects the deduction from the base of the surtax of the schedular taxes paid by each of the taxpayers. It abstracts, however, from the differential impact which may be caused by administrative inefficiency on the tax liabilities of the persons involved.

The outcomes depend to a large extent on whether or not a given overall income derives from more than one source and in what proportions. Thus, e.g. although taxpayers E and J each receive 3 million F.CFA of net taxable income, taxpayer E, who only receives investment income, pays somewhat less income tax than

13. As argued in S. Plasschaert, "The Comparatively Limited Role of Income Taxation in Developing Countries", 37 BIFD 4 (1983).
14. This remark is even more valid when, as was the case in Belgium, until 1962, and in Senegal, until 1976, the surtax itself was deductible from the base of the surtax of the following year.
15. The "technical reasons" for such deductibility, accepted by De Viti de Marco, A. De Viti de Marco, *First Principles of Public Finance* (from the Italian, London, 1950) at 305 are not convincing. In his words, it would eliminate the differential tax burdens in the schedules. But then, what is the purpose of featuring a set of schedular taxes, predicated on the "qualitative discrimination" theory.
16. S. Plasschaert, "Schedular and Global Types of Income Taxation: The Equity Dimension", 34 BIFD (1980) at 287.

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taxpayer J, who receives most of his income from a business and a minor part from employment. The deductibility of the schedular taxes, though, partly neutralizes the rate differentiation which is intended in the schedular part of the system.

It could be objected that the set of differentiated flat rates on the schedular level involves a progressive distribution of tax burdens since capital incomes tend to be heavily concentrated in high-income strata. In other words, the apportionment of tax burdens, which is implicit in a consistently-applied qualitative discrimination principle, would be progressive. Apart from the fact that the theory has often been loosely implemented, the alleged equivalence with a progressive pattern of distribution of tax liabilities is only a broad one; by only taking account of the nature of the incomes, it overlooks the level of each of the partial incomes.

The dualistic system cannot possibly perform better than a consistently-applied global one, in terms of the progressive distribution of vertical tax burdens. In practice, where the exemption level in the surtax is fixed at a relatively high level of total income, progressivity does not apply to income below this threshold. In addition, the schedular system fails to achieve intra-schedular progressivity, i.e. in respect of taxpayers, who receive income from the same source (which is then taxed at a flat rate).

In practice, however, progressivity and personalizing provisions have found their way into the "ground-floors" of dualistic systems. This is particularly the case for income from labour and for "mixed" income from unincorporated business units, which, for the majority of income-earners, may well be their only or, at least, their main sources of income. Such a widespread phenomenon of "partial personalisation"[17] of the "core" schedular taxes, i.e. the taxes on wages and salaries and on commercial income, strongly suggests that the political appeal of the relative ability-to-pay principle is very strong, to the point that the progressive pattern of tax-burden distribution in the surtax is not viewed as adequate and is, therefore, reinforced by some elements of progressivity in one or more of the schedular taxes.

In schedular sets of taxes there is another frequent deviation from what the rules of the book would prescribe. Various incomes from capital tend to be treated much more leniently than the qualitative discrimination theory prescribes. This significantly distorts the intended pattern of tax burden distribution. One must admit, however, that in today's global systems similar tax reliefs for incomes from savings instruments are widespread and that their distortive effect, under progressive rates, is even greater as they benefit the upper-income groups of taxpayers proportionally more than other groups.

17. H. Laufenburger, *Economie du système fiscal français, national et local* (Paris, 1954).

V. ADDITIONAL COMPLICATIONS

The dualistic system results in some additional complications, as compared with a straightforward global arrangement of income taxes.

Number of taxes. The dualistic system, obviously, involves more taxes and rate formulas than a global-type income tax. While such a drawback should not be overemphasized, it nonetheless hampers a better understanding of tax matters by the taxpayers. For those better-to-do taxpayers who are liable to the surtax, a genuine global tax would be more transparent.

The tax base. In principle, the taxable base of the surtax should consist of the sum of all net incomes that are subject to the schedular taxes minus any personalized deductions and the like that are granted for purposes of the surtax. However, such equivalence often does not hold because some items of income are either omitted from or added to the taxable base of the surtax. Almost all dualistic tax statutes provide for a different treatment in some instances of the same income for purposes of the schedular tax and the surtax. To cite only a few examples, in Brazil, prior to 1965, agricultural profits were subject to the complementary tax, but exempted from the relevant schedular tax. In Cameroon, handicraft incomes, while subject to a schedular tax, are not liable to the surtax.

There often exist acceptable administrative or equity considerations for such differential treatment. For instance, only large land-owners may possess sufficient taxable capacity to be liable to the surtax and the ability to apply modern accounting methods. Governments, in allowing differences in the definition of the tax base for the schedular taxes and for the surtax, may pursue specific objectives. Thus, in Belgium, before 1963, a number of public sector bond issues were exempt from the surtax, but not from the schedular tax on movable capital ("taxe mobilière"). This provision favoured selective financial investments, apparently with a view to attract well-to-do investors. However, apart from their questionable merits, such differentiations further complicate the income tax system.

Definition of net income and rate structures. As already stressed, the fact that the surtax is fully personalized and carries openly progressive rates, is consistent with the pattern of a global tax system. But further complications arise when the procedures for "netting out" taxable income and for applying the statutory rates, differ in the surtax and in the schedules. One striking example relates to the French "family quotient" system which is in use in many francophone countries in Africa with a dualistic system, but only for purposes of the surtax, in recognition of the fact that family circumstances should be referred to in determining the overall tax burden. To the extent their "core" schedular taxes are personalized, such an objective is pursued through deductions for family members. All this stands in the way of transparency and blurs the roles which, according to the *Caillaux* concept, should be assigned to each of the two tiers of the dualistic system.

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VI. ADMINISTRATIVE FEASIBILITY

Is a dualistic system more easily amenable to effective administration than a global one? To the extent a comparison can be made – all other things being equal – the following observations appear relevant.

First, as just mentioned, the dualistic system, even assuming that it is not marred by provisions which transgress the rules of the schedular or global models, must be viewed as more complex than a global one and as rendering the task of the tax administration more difficult.

Secondly, the dualistic system may have some merits, in given circumstances, when practical considerations require the use of simple assessment methods. Thus, a flat tax (forfait), of French origin, may be applicable only in the corresponding schedular tax, not in the surtax where progressive rates may apply. Such a flat tax involves a simplified return by the taxpayer and a modest degree of auditing by the fisc. They allow a large number of taxpayers, at low levels of income, in the agricultural, commercial and professional sector, to be brought within the scope of income taxation.

Such arguments in favour of the dualistic system would carry even more weight if it were possible to circumvent the need for a declaration, as when income could be reliably inferred from "external signs".

However, the "external signs" approach, which was widespread in the 19th century in some European countries, notably in France, is no longer appropriate, not even in today's developing countries. As a matter of fact, in the latter, the income tax is essentially a tax on the modern sector. Once the obligation for annual reporting of incomes is introduced, the door is opened for the implementation of a global-type tax, which is definitely preferable, from an administrative viewpoint, to the more complicated dualistic model.

In mentioning the merits which the flat tax and similar approaches may have, one should not overlook, however, the fact that they are not fully effective administrative methods, as they involve some degree of underassessment and accordingly, distort somewhat the intended vertical distribution of tax burdens.

Furthermore, the flat tax method can also be applied within a global tax to lower-income self-employed taxpayers, although, admittedly, here the underassessment involved is more objectionable since progressive instead of proportional rates apply.

Thirdly, the few and somewhat cryptic arguments adduced in favour of the dualistic system (see Section 2) suggest that this two-track approach allows the shortcomings of the surtax to be offset by the virtues of the schedular taxes and vice-versa. However, such compensation does not actually occur, and is not even conceivable. As a matter of fact, if, for whatever reason (e.g. non-declaration and/or ineffective audits by the fisc) a given taxable income escapes schedular tax, there is little likelihood that such underassessment can be remedied for purposes of the surtax. The person who successfully evades the schedular tax will remain equally silent when he fills in his surtax declaration. The dualistic approach does not compensate for administrative inefficiency, it merely duplicates it.

This is aptly illustrated by the treatment of income from bearer securities in dualistic systems. Traditionally, in such systems interest and dividends from securities, whether in registered or bearer form, were taxed at source in the appropriate schedular layer with a flat rate. For purposes of the surtax, the taxpayer had to declare his total income, including the income derived from bearer securities. Non-declaration or under-declaration, however, continued largely undiscovered and without penalty. To remedy this tax evasion, the measure sometimes resorted to consisted of subjecting the income to another withholding tax[18], under the surtax, at a flat rate, unless the taxpayer identified himself, and included such income in his declaration. Such methods, apart from being only partially effective, on account of the rather low withholding rate, further add to the complexity of dualistic systems.

If the assessment in schedular taxes employs a less effective method, such as the flat tax or another presumptive approach, one fails to see why and how a more foolproof method would be implementable in the surtax, except with respect to the few agricultural producers and businessmen whose units have become modern and who keep reliable accounting records. In the case, however, of France, under the dualistic system, the flat rates, established under the schedular taxes were transplanted, without modifications, into the surtax.

Finally, the very fact that, for purposes of the surtax, a declaration is required does not, in itself, ensure the effectiveness of the assessment, unless the fisc is prepared to use efficient auditing methods. But there is no compelling reason why the fisc would not attempt to base the assessment process on real incomes and not on presumptive ones. A global-type income tax would then be more appropriate than a dualistic one, and comparatively simpler.

VII. CONCLUSION

In sum, the dualistic model has little if anything to commend itself. When launched in France in the early years of this century, its virtues were praised in vague political terms and not substantiated by solid analysis. Upon inspection, this approach does not allow for a mutual compensation of the shortcomings of the schedular and the global approach. This disappointing outcome was to be expected, in any event. The advocates of the dualistic model overlooked the fact that methods of assessment are not specific to a given model of income taxation, but are conditioned by the economic and legal characteristics of each type of income. Besides, the vertical burden distribution from the dualistic system is bound to be haphazard, even if

18. For example in Belgium, in 1961, on the eve of the tax reform which substituted a global for a dualistic system, an extra withholding tax as part of the surtax was instituted. Such "complementary withholding tax on movable income" (complément de précompte mobilier) was maintained under the new global tax, until 1967.

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the rules of the qualitative discrimination theory would be properly heeded as in the earlier schedular systems. The deductibility of the schedular taxes in the surtax creates additional distortions in tax burdens. All in all, the dualistic system does not have qualities that would warrant it being preferred over the global system. It, therefore, comes as no surprise that it has met with little, if any, approval in the modern tax literature.[19]

The preceding discussion suggests only two reasons for recommending – rather, for tolerating – a dualistic system. First, it could provide for a transitional stage between a schedular system and a global one in circumstances in which, due to the comparatively low level of per capita income and of intellectual sophistication in large segments of the society, and to the difficulty of effectively reaching a large agricultural sector, the objective of implementing a full-fledged global system appears unrealistic. Indeed, a global system implies comprehensiveness and homogeneity in the taxable base. Within the dualistic system, less sophisticated assessment methods could then be used, particularly as regards the schedular layer.

Another, although less rational, argument in defence of a dualistic model as a transition towards a genuine global system derives from political constraints. The introduction of a global-type income tax in France proved unpalatable, on account of opposition by conservative circles which rightly perceived that an audited annual return is the linchpin in a global system and which attempted to prevent the introduction of such a declaration.

19. The dualistic model has not enjoyed much support by modern tax scholars. At a major conference about tax policies in Latin America, *R. Goode* concluded that "the combination of schedular taxes with a global complementary tax does not appear to imply major advantages or drawbacks as compared to the unitary (global) tax"R. Goode, "El impuesto sobre la renta en America Latina", in: *Reforma tributaria para America Latina: Il Problemas de Politica Fiscal* (Santiago Conference, Joint Tax Program: 1962) at 250. The views defended in this chapter go further in that they deem the mixed system definitely inferior.

Tax burden for same overall income[1] of different composition: Senegal (1984)

Tax-payers	Wages salaries	Self-employed profes-sionals	Unincor-porated business profits	Urban rents	Dividends	Schedular taxes		Complementary global tax		Total tax liability
						Absolute	in %	Absolute	in %	
A	3,000,000 (264,000)					264,000	8.80	627,900	20.93	29.73
B		3,000,000 (722,400)				722,400	24.08	489,600	16.32	40.40
C			3,000,000 (722,400)			722,400	24.08	489,600	16.32	40.40
D				3,000,000 (600,000)		600,000	20.00	527,100	17.57	37.57
E					3,000,000 (480,000)	480,000	18.00	563,100	18.77	36.77
F		1,500,000 (302,400)		1,500,000 (300,000)		602,400	20.08	526.500	17.55	37.63
G			1,500,000 (302,400)		1,500,000 (240,000)	542,400	18.08	544.500	18.15	36.53
H	2,500,000 (214,000)			500,000 (100,000)		314,000	10.46	612,900	20.43	30.85
I	2,500,000 (214,000)				500,000 (80,000)	294,000	9.88	618,500	20.61	30.49
J	500,000 (8,000)		2,500,000 (582,400)			611,200	20.37	523,680	17.46	37.83

1. Tax liabilities are shown within brackets for single taxpayer.
Source: Author's calculations. The table compares 10 taxpayers whose overall taxable income totals F.CFA 3,000,000.

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PEOPLE'S REPUBLIC OF CHINA:

The New Regulatory Tax on Individual Income

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I. INTRODUCTION

Taxation in China is almost as old as the country itself: records of a land tax go back at least as far as the 16th century B.C. and a progressive personal income tax was imposed as early as 780 A.D., though it seems to have been short-lived, as have been a number of subsequent attempts to tax income. The first income tax in the modern sense was introduced, without ever being enforced, in 1913. In 1936, an Income Tax Act was formally promulgated by the Guomindang Government[1]. In 1950, after liberation, the new Chinese Government established a new tax system[2] and made income tax a part of the industrial and commercial tax[3], without introducing an independent income tax, although a wages and salaries income tax had been proposed. The State Budget revenue soon came to be provided mainly by State enterprises, which controlled all major sectors of the nation's economy for the following decade.

The present income tax system started in 1980 with the introduction of the Joint Venture Income Tax Law[4] and the Individual Income Tax Law[5]. In 1981, the promulgation of the Foreign Enterprise Income Tax Law[6] completed the taxation system concerning foreign individuals and enterprises doing business in China. Between 1983 and 1986, three more business income taxes were promulgated applying to State-owned[7], collectively-owned[8] and privately-owned en-

1. The Provisional Regulations concerning the Income Tax were promulgated on 21 July 1936 and entered into force on 1 October of the same year. This tax law was based on the British schedular system and divided income into three categories: (a) business income of industrial and commercial enterprises and corporations; (b) employment income of employees working in factories and offices; and (c) income from securities and deposits. In 1938 and 1943, the then Government introduced "Excessive Income Tax during the Extraordinary Period" to collect revenue for waging the Anti-Japanese War (1937-1945). See Wang Kun, *Guojia Shuifa Gailun (Introduction to the Nation's Taxation)*, published by Huadong Gongxueyuan Press, 1985, at 184-185.
2. The Principal Rules for Implementation of the National Tax Administration, promulgated on 27 January 1950, constituted the first tax legislation in the People's Republic of China. Under this law, there were to be 14 taxes enforceable in China, including commodity tax, industrial and commercial tax, salt tax, customs duties, wages and salaries tax, interest income tax, stamp tax, inheritance tax, transaction tax, slaughter tax, house tax, land tax, special consumption tax and vehicle licence tax. Except for the wages and salaries tax and the inheritance tax, which were never introduced, all other taxes were collected according to separate governing tax laws.
3. The Provisional Regulations concerning Industrial and Commercial Tax were promulgated on 19 December 1950. All industrial and commercial profit-making enterprises in China, whether State-owned, privately-owned, joint public/private, and cooperatives, were subject in principle to this tax. Income tax was a component of this tax, which was paid by all taxpayers except State-owned enterprises. Until 1980, this was the only tax on business profits. In 1958, the other components of the tax were consolidated, together with a number of commodity taxes, into the consolidated industrial and commercial tax, leaving the industrial and commercial income tax standing alone.
4. The Income Tax Law of the People's Republic of China concerning Chinese-Foreign Joint Ventures was promulgated and became effective on 10 September 1980.
5. The Individual Income Tax Law of the People's Republic of China (hereinafter referred to as the IIT Law) was adopted by the Third Session of the Fifth National People's Congress and became effective on 10 September 1980.
6. The Income Tax Law of the People's Republic of China concerning Foreign Enterprises was adopted by the Fourth Session of the Fifth National People's Congress and promulgated on 13 December 1981.
7. The Provisional Regulations concerning the Collection of State-Enterprise Income Tax of 29 April 1983 provide that all profit-making State enterprises shall pay income tax. The tax rate for big and medium-sized enterprises is a flat 55%; for small ones, the rates are progressive ranging from 10% to 55% of the profit. The size of the enterprise is determined on the basis of the amount of fixed capital assets and the number of workers. Before this tax was introduced, State enterprises were required to turn in all their profit to the State and losses were borne by the State. That system was considered to lack incentives and efficiency.
8. The Collective-Enterprise Income Tax Regulations of 11 April 1985 provide that all collective enterprises engaged in industrial and commercial activities shall pay this income tax. The applicable tax rates vary from 0% for income less than 1,000 yuan to 55% for taxable income exceeding 200,000 yuan.

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terprises[9]. Another personal income tax law was adopted by the State Council on 25 September 1986 and came into effect on 1 January 1987[10]. This tax applies only to Chinese citizens resident in China, leaving "resident aliens" and non-residents to continue to be taxed under the ITT Law. It substantially increases the tax burden on income from employment, from professional services, rents and royalties, and will, of course, apply to the Chinese employees and executives of foreign firms doing business in China. It is this regulatory tax that the writer of this article intends to discuss.

II. INDIVIDUAL INCOME REGULATORY TAX

A. Reasons for the imposition of the tax

Although under the IIT Law "all individuals residing for one year or more in the People's Republic of China" are required to pay this personal income tax[11], most Chinese citizens were effectively exempted because of the high amount of basic exemption, i.e. only monthly income in excess of 800 yuan was taxed. This equals approximately US$ 200 and corresponds to approximately eight times the average wage in China. Those Chinese who did pay this tax were mostly those receiving income other than wages and salaries.

The 1980 IIT Law was adopted mainly for the purposes of satisfying the needs of the "open door" policy and was designed principally to tax foreigners living and working in China: the amount of deduction of expenses is relatively high and is not suitable to the income level of ordinary Chinese citizens. Thus, it could not effectively regulate the income differences among them. The amending of the IIT Law, by way of a reduction of the amount of expenses or exempted income, was considered not to be workable due to the possible negative effect on the "open door" policy[12].

Another major reason for promulgating this regulatory tax is that the income level of many Chinese citizens has changed dramatically from what it was in 1980. At present, many individuals receive income not only in the form of wages and salaries, but also in the form of contractual fees, dividends, interest, royalties and bonuses[13]. Many of them obtain several 1000 yuan a month, some even earning as much as 10,000, which enormously exceeds the average income enjoyed by ordinary workers, peasants and cadres. "The difference is just too great. It is necessary to regulate by means of a tax."[14] It is believed that through the implementation of the regulatory tax, the difference among individuals can be adjusted; the principle of "from each according to his ability, to each according to his work" can be better observed; and the economic reform can be better carried out[15].

B. Taxpayers

All Chinese citizens who have a dwelling place (domicile) in China and obtain personal income are taxpayers for purposes of this regulatory tax[16]. Therefore, aliens and non-resident citizens deriving income from China are not covered. The place of domicile is defined to be the place where the citizen's household registration[17] is kept. Where he maintains a regular residence at a different place, the regular residence is treated as his domicile[18].

C. Taxable income

Individual income regulatory tax is levied on the following categories of income:

(i) income from wages and salaries (this is the same as under the 1980 IIT Law);
(ii) income from contractual and sub-contractual fees (with the introduction of rural and urban economic reforms in 1978, individuals were encouraged to contract with their working unit, such as communes, factories or shops, to manage the operation of the business and to become fully responsible for the profit and loss thereof. Income exceeding the contracted amount payable to the other contracting party can be freely disposed of by these individuals);
(iii) income from remuneration for personal services[19];

9. Interim Regulations of the People's Republic of China on Income Tax concerning Urban and Rural Individually-Operated Industrial and Commercial Businesses, promulgated on 7 January 1986, provide that all profit-making private enterprises are liable to this income tax at rates ranging from 0% (if income is less than 1,000 yuan) to 60% (annual income in excess of 30,000 yuan). A 10% to 40% surtax is levied on any taxable income exceeding 50,000 yuan. It is obvious that tax treatment of private enterprises is less favourable than that of State enterprises and collective enterprises.
10. The text of the Interim Regulations concerning the Individual Income Regulatory Tax (hereinafter referred to as the Regulations) was published in *Renmin Ribao (People's Daily)* of 12 December 1986. The author's translation is appended hereto.
11. IIT Law, Art. 1.
12. See the Editorial Notes in *Zhongguo Fazhi Bao (China's Legal System)* of 12 December 1986.
13. For example, Wan Tingbao, a peasant in Jiangsu Province, earned the equivalent of $ 74,000 (Canadian) a year from renting four hectares of waterlogged land for a pearl oyster farm. With the introduction of the Government rural economic reforms, many farmers became rich, and Wang was one of them: see *The Globe and Mail,* Toronto, 1 December 1986, p. A12.
14. Supra note 12. The rapid increase of personal income also causes some fluctuations of the market.
15. For further explanation, see an interview of officials of the Tax Bureau of the Ministry of Finance by some newspaper reporters: *Renmin Ribao,* 12 December 1986.
16. Article 2 of the Regulations. An unofficial translation is provided by the writer in the Appendix following this article.
17. In China, every citizen must be registered with the local public security bureau in due time after his (her) birth.
18. See Article 15 of the Civil Code of the People's Republic of China, which was adopted and promulgated by the Fourth Session of the Sixth National People's Congress and became effective on 1 January 1987.
19. "Personal services" are not defined in this Regulatory Tax Law, but reference can be made to Article 4(2) of the Regulations for the Implementation of the Individual Income Tax Law (IIT Regs.). The expression is there defined to include "designing, installation, drafting, medical practice, law practice, accounting, consulting, lecturing, news reporting, broadcasting, free-lance writing, translating, calligraphy and painting, sculpture, films, drama and opera, music, dancing, acrobatics, ballad singing and comic talk, sports, technical services and other personal services".

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(iv) income from the lease of property[20];
(v) income from the transferring or licensing of patent rights and from providing non-patented technology;
(vi) income from the submission of writings or translations for publication;
(vii) income from interest, dividends and bonuses; and
(viii) other kinds of income specified as taxable by the Ministry of Finance[21].

D. Tax rates

Two types of rates are provided in the Regulations: *progressive rates* and *proportional rates*. The progressive rates apply if the aggregated monthly amount of income under Article 3(i), (ii), (iii) and (iv) is four times greater than the Basic Regional Taxable Amount (BRTA)[22]. The BRTA is determined by the wage level of different regions, which is set by the State, taking into consideration the price levels in various regions of the country. For example, Beijing is in Region 6, Shanghai in Region 8 and the remote areas (such as Tibet and Xinjiang) are in Regions 10 or 11. The tax rates applicable to various regions are listed in the Appendix to the Regulations. Taking Beijing as an example, the monthly BRTA is 100 yuan: if a citizen receives income exceeding 400 yuan, the excessive part is taxable at the following rates:

20% if the amount of income is between 401-500 yuan;
30% if the amount of income is between 501-600 yuan;
40% if the amount of income is between 601-700 yuan;
50% if the amount of income is between 701-800 yuan;
60% if the amount of income is more than 800 yuan.

Four Basic Regional Tax Amounts (they are 100, 105, 110 and 115 yuan)[23] are provided in the Regulations, thus one single rate applies to four different amounts of personal income depending upon the region in which the individual is domiciled.

A 20% proportional rate is applied to items of income covered under Article 3(v), (vi) and (vii).

A further distinction can be made based on the deductibility of expenses. For income from submitting writings and translations for publication, from transferring or licensing patent rights, and from providing non-patented technology, a deduction of 800 yuan is allowed for expenses if the amount received in a single payment is less than 4,000 yuan; and, a deduction of 20% is allowed if the amount received in a single payment is 4,000 yuan or more. For income from interest, dividends and bonuses, no deduction is allowed and a 20% tax rate is imposed on each payment received[24].

The tax rates applicable to income under Article 3(viii) are to be determined by the Ministry of Finance[25].

E. Exempt income

As is the case under the 1980 IIT Law, certain kinds of income are exempt from the regulatory tax, including the following: (i) awards for scientific, technological and cultural achievements by provincial governments, the State Council or higher governmental organs; (ii) interest from State bonds and financial bonds issued by the State[26]; (iii) interest on savings deposits in the State banks, credit cooperatives and post offices[27]; (iv) subsidies and allowances such as settling-in allowances, severance fees, retirement fees, etc. paid in accordance with State regulations; (v) military severance payments, welfare benefits, pensions for disabled persons and survivors and relief payments; (vi) insurance proceeds; and (vii) other income approved by the Ministry of Finance[28].

F. Tax administration

Two methods of tax collection are provided in the Regulations: withholding at source and the filing of a tax return personally by taxpayers. For those items of income that should be integrated, i.e. employment income, contractual fees, remuneration for personal services and rentals, a taxpayer is required to file a tax return with the local tax authorities and pay the regulatory tax. Tax on other types of income that are taxed at a flat rate, which also include each component of the integrated income if the payment exceeds three times the BRTA, shall be withheld by the payor at the appropriate rate when the payment is made. A service fee of 3% or less is payable to the withholding agent[29].

Every citizen is obliged to inform the tax authorities if he discovers that there is tax avoidance or tax evasion by any taxpayer. The tax authorities shall protect the informant by keeping his name secret and by duly rewarding him[30].

III. CONCLUSIONS

Both the 1980 IIT Law and the present Regulations concern schedular taxes, different kinds of income

20. The interpretation of the term "income from the lease of property" can be understood to be "income from leasing buildings, machinery and equipment, motorized vehicles and boats and ships, and other kinds of property": Article 4(5) of the IIT Regs.
21. Regulatory Tax Law, Art. 3.
22. See Appendix. The text actually refers to the amount by which excess income exceeds 3 times the BRTA. That is to say, the BRTA, plus a further 3 times that amount, is exempt.
23. The BRTA can be adjusted by the Ministry of Finance after approval of the State Council: Regulations, Art. 6.
24. Regulations, Art. 7.
25. Regulations, Art. 8.
26. Certain interest from bonds issued by enterprises can also be exempt with the approval of the Ministry of Finance. For instance, the interest derived from bonds issued by the Shanghai Ethylene Plant has been approved by the Ministry of Finance to be exempt from personal income tax: see *Renmin Ribao,* (overseas edition), 26 November 1986.
27. Currently, Chinese individuals are able to have savings deposits in post offices and withdraw the money in certain specified post offices in some major cities including Beijing, Shanghai and Guangzhou. This system provides a great convenience for persons from other parts of China who can travel or do business in these cities without having to carry cash with them.
28. Regulations, Art. 9.
29. Regulations, Arts. 10-14.
30. Regulations, Art. 16.

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being taxed differently. The language used in these two laws is also similar except for the following variations:

(i) Under the IIT Law, only employment income is subject to progressive rates. Remuneration for personal services and rental income are taxed at a flat 20% rate after a deduction for expenses. Under the regulatory tax, however, these categories of income are subject to progressive rates ranging from 20% to 60%.
(ii) More notably, the exemption under the IIT Law (800 yuan) is much higher than that under the regulatory tax (400 yuan).
(iii) The progressive tax rates vary tremendously between the two: 5% to 45% under the IIT Law (only on wages and salaries), as compared to 20% to 60% under the regulatory tax. For example, the rate applicable to a monthly income exceeding 800 yuan is 5% under the IIT Law and 60% under the regulatory tax.
(iv) Some situations relate only to Chinese citizens, such as contractual fees. Exempted income regarding severance payments to Chinese cadres is dealt with in the regulatory tax, but not the IIT Law.

It should be noted that even under the new regulatory tax the majority of Chinese citizens will still pay no personal income tax, considering the general level of individual income in China. Tax liability of foreign individuals staying and working in China is not affected by the provisions of the new tax and the IIT Law still applies to them. Because of the lower exemption amount under the regulatory tax, Chinese citizens are not liable to pay IIT.

APPENDIX*

Provisional Regulations concerning individual income regulatory tax of the People's Republic of China

(Promulgated by the State Council on 25 September 1986)

1. These Regulations are promulgated for the purposes of regulating the differences among individuals in personal income and promoting the successful carrying-out of the economic reform.

2. Chinese citizens who have a domicile in the People's Republic of China and obtain personal income are taxpayers of this regulatory tax (hereinafter referred to as "taxpayers") and shall pay individual income regulatory tax in accordance with these Regulations.

3. Individual income regulatory tax shall be levied on the following categories of income:
(i) Income from wages and salaries.
(ii) Income from contractual and sub-contractual fees.
(iii) Income from remuneration for personal services.
(iv) Income from the lease of property.
(v) Income from transferring or licensing patent rights and providing or transferring non-patented technology.
(vi) Income from submitting writings for publication and from translation.
(vii) Income from interest, dividends and extra dividends.
(viii) Other kinds of income specified as taxable by the Ministry of Finance of the People's Republic of China.

4. Individual income regulatory tax is computed and levied at progressive rates on the excess amount, or at proportional rates according to the source of the income.

5. The items of income under (i) to (iv) of Article 3 of the Regulations shall be integrated and pay regulatory tax every month based on the Basic Regional Taxable Amount. Where the monthly integrated income exceeds the Basic Regional Taxable Amount, only the amount of income which exceeds three times more than the Basic Regional Taxable Amount is taxable at the progressive rates (see the tax rates in the Chart).

6. The Basic Regional Taxable Amount can be adjusted according to real situations. The adjustment of the Basic Regional Taxable Amount shall be determined by the Ministry of Finance and approved by the State Council.

7. The following items of income shall be taxed at proportional rates:
(i) For income from submitting writings, translation for publication, transferring or licensing patent rights, providing or transferring non-patented technology, a 20% rate of regulatory tax shall be imposed after a deduction of 800 yuan for expenses if the amount received in a single payment is less than 4,000 yuan, and a 20% deduction for expenses if the amount received in a single payment is 4,000 yuan or more.
(ii) Income from interest, dividends and extra dividends shall be taxed at a 20% rate on the amount received in each payment.

8. The applicable rates to income under paragraph (viii) of Article 3 shall be determined by the Ministry of Finance.

9. The following categories of income shall be exempted from individual income regulatory tax:
(i) awards for scientific, technological and cultural achievements by provincial governments, the State Council or higher level of governmental organs;
(ii) interest from State bonds and financial bonds issued by the State;
(iii) interest on savings deposits in State banks, credit cooperatives, and post offices;
(iv) subsidies and allowances received from the State according to the State regulations;
(v) welfare benefits, pensions for the disabled and for survivors and relief payments;
(vi) insurance proceeds;
(vii) military severance payment and decommission or demobilization payment for cadres and soldiers of the armed forces;
(viii) settling-in allowances, severance fees, retirement fees, wages and living allowances received by cadres after retirement; and
(ix) income exempted from tax with the approval of the Ministry of Finance of the People's Republic of China.

10. Individual income regulatory tax shall be paid in two ways: withholding by the payor at source and filing a tax return by the taxpayer.

11. The paying unit of the categories of income covered by Article 3 of the Regulations shall act as a withholding agent and calculate and withhold tax according to the following methods:

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(i) regulatory tax shall be withheld if each component of the integrated income is more than 3 times the Basic Regional Taxable Amount at the appropriate rate;
(ii) regulatory tax on income from submitting writings and translations for publication, transferring or licensing of patent rights, providing or transferring non-patented technology shall be withheld at the appropriate rate after a deduction for expenses is made according to the provisions of Article 7(i);
(iii) regulatory tax on income from interest, dividends and extra dividends shall be withheld according to the provisions of Article 7(ii).

12. If a taxpayer's monthly integrated income exceeds the Basic Regional Taxable Amount, he shall file a tax return personally to the local tax authorities for the part of income which is 3 times more than the Basic Regional Taxable Amount.

13. Taxpayers who file their own tax returns and withholding agents shall submit tax returns to the local tax authorities within the first 10 days of each month, and pay the amount of tax that is due to be paid or withheld for the previous month.

14. Tax authorities shall pay a service fee of 3% or less of the amount of withholding tax to the withholding agent.

15. The administration of these Regulations shall be conducted in accordance with the provisions of the "Interim Regulations concerning Tax Collection and Administration of the People's Republic of China".

16. Any person is authorized to inform the tax authorities of the case that a taxpayer has not paid regulatory tax properly under the Regulations. Tax authorities shall keep the name of the informant confidential and grant certain rewards to the informant.

17. These Regulations shall be interpreted by the Ministry of Finance. Implementary regulations for these Regulations shall be made by the Ministry of Finance.

18. These Regulations shall go into effect on 1 January 1987.

Chart: Individual income regulatory tax rates

Categories	I	II	III	IV	
Applicable Wage Region	Region 6 & Below	Regions 7 & 8	Regions 9 & 10	Region 11	
Basic Regional Taxable Amount	100 yuan	105 yuan	110 yuan	115 yuan	
Times exceeding the BRTA	Monthly integrated taxable amount (yuan)				Tax rates (%)
3 Times	400-500	420-525	440-550	460-575	20
4 Times	501-600	526-630	551-660	576-690	30
5 Times	601-700	631-735	661-770	691-805	40
6 Times	701-800	736-840	771-880	806-920	50
7 Times	more than 800	more than 840	more than 880	more than 920	60

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PHILIPPINES:

Experience with Tax Amnesty Legislation

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I. INTRODUCTION

A *tax amnesty law* is generally understood as one which condones the liabilities incurred by a taxpayer pursuant to his non-payment or incorrect payment of taxes subject to the condition that such erring taxpayer shall comply with certain requirements. Such is the concept of a tax amnesty in the Philippines with variations only as regards the extent of coverage, nature of immunity and/or privileges afforded, amount of the compromise amnesty tax and other incidental requirements. From the viewpoint of tax enforcement, a tax amnesty results in a freezing of the investigative and auditing stages that the Government ordinarily undertakes to give a chance to taxpayers to invoke the protection and privileges granted by the amnesty.

A study prepared by the National Tax Research Center (NTRC) estimated that income tax evasion[1] of individual taxpayers in 1984 alone was around ₱9.2 billion. The study, however, did not estimate the level of tax evasion for other years. If we assume that this is the annual tax evasion for 5 years, the accumulated tax evasion would reach a staggering amount of ₱46 billion. How do we recoup such a big drain to Government coffers? One way is to declare tax amnesty so that taxpayers can be given a chance to have a clean slate with respect to their tax liabilities and, at the same time, generate much needed revenues for the Government. Assuming that only 10% of the accumulated evasion for 5 years can be collected, this would mean an increment of ₱4.6 billion.

A tax amnesty issuance presupposes the existence of tax evasion cases. Tax evasion refers to the non-payment or fraudulent payment of taxes required to be paid under existing tax legislations. The payment of taxes being compulsory, statutory taxpayers therefore become liable to the sanctions provided for by law in case of non-declaration or misdeclaration of the taxable objects which are within the taxpayer's disposal. Such sanctions consist of administrative, civil and criminal liabilities attached to the tax violation, e.g. payment of interest and surcharges, fines and imprisonment. A tax amnesty law relieves the taxpayer of such liabilities provided he complies with certain conditions.

There are advantages and disadvantages of a tax amnesty legislation. Its advantages may be summed up as follows:[2]

(a) it gives errant taxpayers the opportunity to comply with the tax law and start a clean slate without fear of penalty;
(b) it eases tax administration in the sense that tax enforcers need no longer go to the rigors of identifying, verifying and prosecuting tax evaders;
(c) it may result in net revenue gain to the Government; and
(d) it is attuned with the spirit of reconciliation between Government and the citizenry and which could result in upgrading the level of public tax consciousness.

On the other hand, the disadvantages of a tax amnesty grant may be summarized as follows:[3]

(a) it may be interpreted as a sign of weakness on the part of Government and its enforcement mechanism;
(b) it becomes unfair to taxpayers who religiously paid their taxes due to the punitive sanction of the tax law; and
(c) when granted more oftenly, taxpayers might be encouraged to relax in the fulfilment of their tax obligations motivated by the speculation that another tax amnesty is in the offing.

* The author is grateful to Atty. Sison Jarapa, Asst. Chief, Direct Taxes Branch, National Tax Research Center, for his assistance in the completion of this manuscript.

1. Tax evasion is illegal per se. In contrast, tax avoidance is not illegal as this denotes the employment of means or schemes to reduce the taxpayer's tax burden through legally permissible methods.
2. NTRC Study, dated 6 September 1985.
3. Ibid.

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The granting of tax amnesty as a recognized mechanism of tax administration is not exclusive to the Philippines. Tax amnesty legislations have been enacted in Brazil, Chile, Colombia, India, Indonesia, Israel and Switzerland, among others, covering unpaid income taxes.[4] As in the Philippines, these tax amnesties were subject to certain conditions such as the voluntary disclosure of correct income or wealth during certain taxable periods and the foregoing of certain tax liabilities. In Brazil, Colombia, and India, an additional condition was imposed, i.e. the disclosed income should have to be invested in certain specific ventures such as the purchase of treasury bonds, municipal bonds and special Government bonds. These countries generated substantial amounts of revenue from the undeclared or unreported taxable incomes or wealth of those who availed of the tax amnesty law. For instance, Israel had about 1,400 taxpayers who reported previously undeclared income amounting to about 89 million Israeli Pounds (US$ 25 million)[5] while Switzerland was able to disclose previously undeclared assets of about 11 billion francs (US$ 2.55 billion).[6]

In the Philippines, there were 10 amnesty decrees enacted during the time of former President Marcos. In a span of 10 years from 1972 to 1981, 6 tax amnesty decrees were issued for previously untaxed income and/or wealth and 4 amnesty decrees for untaxed motor vehicles, untaxed or improperly taxed goods, non-filers of income tax and disputed assessments.[7] Under the new regime, President Corazon C. Aquino has already issued 3 Executive Orders granting one-time tax amnesty on previously untaxed income, delinquent real property taxes, and disputed assessments.[8]

The various amnesty laws promulgated in the Philippines are the subject of this paper focusing on their highlights, rationale and significant implications. An overview of the Marcos and Acquino tax amnesties laws is first presented followed by comments and assessment thereof in the latter part.

II. OVERVIEW OF TAX AMNESTY DECREES UNDER THE MARCOS REGIME

A. Amnesties on untaxed income or wealth

1. Presidential Decree No. 23, issued 16 October 1972

A few weeks after the declaration of martial law in the Philippines,[9] Presidential Decree (PD) No. 23 was issued proclaiming a tax amnesty in consonance with the Government policy to give tax evaders the chance to reform and be a part of the New Society.[10] It was believed that tax evaders were willing to comply with their tax obligations, but were reluctant to disclose their income tax liabilities because of the civil, criminal and administrative penalties attendant to tax violation.

Coverage and immunity. The amnesty covered previously untaxed income derived by any natural or juridical taxpayer during taxable years 1971 and earlier. Such untaxed income included that earned from sources inside and outside the Philippines. Any taxpayer who availed himself of the amnesty was granted condonation of unpaid income taxes and the penalties incident to non-payment. Also condoned were civil and criminal liabilities imposed under pertinent laws in the Philippines such as the National Internal Revenue Code (NIRC), Revised Penal Code, Anti-Graft and Corrupt Practices Act or any other law. There was also freedom from investigation and examination of the amnesty return.

To effect a more secure atmosphere, PD No. 67 (issued 24 November 1972) was promulgated providing for the *inadmissibility in evidence* of the amnesty return in any judicial, quasi-judicial or administrative proceedings in which the amnesty taxpayer is defendant or respondent. It was also made unlawful for any official or employee to disclose to any person any information relative to the amnesty return or declaration.

Conditions. For the tax amnesty to be available, PD No. 23 required payment of 10% of the previously untaxed income declared which shall be in lieu of the income taxes due and the penalties required to be paid such as interest and surcharges. Specific dates for filing the amnesty return and payment of the amnesty tax, whether in full or instalment basis, were prescribed. With respect to untaxed income in the form of cash hoarded abroad, the same should be repatriated to the Philippines for deposit in any Philippine bank or investment in Government bonds, securities and debentures or in any productive enterprise within 6 months from the time of disclosure.

2. Presidential Decree No. 157, issued 16 March 1973

This decree offered amnesty to those who failed to declare their 1972 income faithfully. It was surmised that for the period 1 January 1972 up to the proclamation of martial law on 21 September 1972, some sectors had laboured under the "inertia of past practices and wrong-doings thereby leaving some of their incomes, wealth and other acquisitions unrecorded and/or unreported, rendering themselves liable to sanctions provided under existing laws".

Coverage and immunity. This amnesty law was more limited since it applied only to taxable year 1972 and

4. NTRC Paper entitled "Income Tax Amnesties in Selected Countries", dated 22 August 1986.
5. Under the Israel Income Tax Amnesty of 1967, a tax of 25% of newly reported income for all taxable years until 1965 was imposed.
6. This was imposed under the General Tax Amnesty of 1969. The amount included taxes other than income under the said General Tax Amnesty.
7. An overview and assessment of tax amnesty performance is discussed in Angel Q. Yoingco and Vicente G. Quintos, *Philippine Tax System Under the New Society*, published by GIC Enterprises: pp. 369-380.
8. Another is in the offing which pertains to foreign exchange illegally hoarded or stashed abroad.
9. Proclamation No. 1081, promulgated 21 September 1972, placed the Philippines under Martial Law and empowered President Marcos to assume legislative powers.
10. "New Society" was the term ascribed to the Philippine Society upon declaration of martial rules.

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only to those who availed themselves of PD No. 23 with respect to untaxed income for taxable years 1971 and earlier. The same immunity and privileges granted under the first income tax amnesty law were made available.

Conditions. In the case of taxpayers following the calendar year basis (1 January to 31 December 1972), the amount of amnesty tax required to be paid was either the amount shown on the return *or* an amount equal to the income tax paid in 1971 *plus* 40% thereof, whichever was higher. On the other hand, in the case of taxpayers on the fiscal year basis (12-month period other than calendar year), which applied to those in business, the amnesty tax was whichever was higher of the following amounts:

(1) the amount of tax shown on the return filed, *or*
(2) the amount equal to the sum of (a) an amount which bears the same ratio to the income tax paid for the immediately preceding fiscal year as the period covered by the return required herein to be filed bears to one entire fiscal year *and* (b) 40% of the amount determined under (2)(a) hereof.

Additionally, deadlines for filing the amnesty return and payment of the tax were also set forth in the same decree.

3. Presidential Decree No. 370, issued 7 January 1974

As of the time of issuance of PD 370, it was believed that there still remained a considerable number of taxpayers willing to avail themselves of the tax amnesty law or make amendments on their tax amnesty returns, but PD Nos. 23 and 157 had already expired. Thus, consistent with the "avowed policy of Government to afford every opportunity to all taxpayers to come within the fold of the reforms of the New Society," PD 370 was promulgated.

Coverage and immunity. The coverage of this third amnesty law was broader – previously untaxed income and/or *wealth* such as earnings, receipts, *gifts, bequests or any other acquisitions.* It applied to natural and juridical persons on income or wealth derived from the Philippines or abroad. It extended the tax amnesty to taxpayers who had already availed themselves of previous amnesties, but failed to include all that were required to be declared, as well as to taxpayers who for any reason failed to avail themselves of or heed the two previous tax amnesties. But although issued in 7 January 1974, the taxable years covered were the years *prior to 1973,* meaning taxable year 1972 and prior years, which were the same periods covered already by the earlier two amnesty laws.

This amnesty law, however, was *not* made to apply to the following:
(1) capital gains transactions,
(2) withholding tax liabilities,
(3) tax liabilities with assessment notices,
(4) tax cases with valid information (pending in courts), and
(5) property transferred by reason of death or donation in 1972.

The same immunity and privileges granted under the previous amnesty laws were adopted.

Conditions. The amnesty law was fixed at 15% of the previously untaxed income and/or wealth. The usual dates for filing[11] and payment were prescribed plus the requirement of repatriation of untaxed cash hoarded abroad.

4. Presidential Decree No. 631, issued 6 January 1975

This amnesty law, called the *ultimate tax amnesty,* raised the following justifications: (a) it is "consistent with its (Government's) policy of persuasion and conciliation aimed at promoting national solidarity and cooperation," and (b) that "Government, in requiring thruthful disclosure of untaxed income as a token of reformation, is likewise willing to grant immunity from investigation of the statement of assets, liabilities and net worth" filed by taxpayers.

Coverage and immunity. This law covered 1973 and prior years. The same exceptions provided for under PD 370 (third amnesty law) were substantially adopted. The usual relief from civil, criminal and administrative liabilities including freedom from investigation was incorporated. However, an exception to the freedom from investigation or examination of amnesty returns was also inserted to the effect that in case the amnesty taxpayer claims a refund, tax credit or tax incentive, he could be investigated even as regards to his amnesty return. The immunity extended to the statement of assets, liabilities and net worth.

Conditions. The amnesty tax payable was equivalent to 20% of the previously untaxed income and/or wealth. As an additional condition, the taxpayer was supposed to file a statement of assets, liabilities and net worth as of 31 December 1973.[12] There were also deadlines fixed for filing the returns and the statements as well as for payment of the amnesty tax.

5. Presidential Decree No. 1740, issued 17 September 1980

What was denominated as the *ultimate tax amnesty* (PD 631, discussed earlier) proved to be the last amnesty only with respect to unpaid taxes for taxable years 1973 and earlier. This is because another decree was issued 5 years later proclaiming another tax amnesty but this time to cover unpaid taxes for taxable years 1974 to 1979. PD No. 1740 was issued in response to the clamour of a "substantial number of individuals who have evaded payment of income taxes and who are now amenable to the filing of the amended tax returns". Moreover, it was felt that there was an "urgent need to update the Government's statistics on the assets, liabilities and net worth of taxpayers in the country for purposes of tax and economic planning."

11. PD 563, dated 30 September 1974, extended the effectivity of this amnesty to 27 November 1974, in conjunction with the extension (by the same decree) of the filing of assets, liabilities and net worth.
12. PD 379, issued 21 January 1974, required taxpayers with assets worth ₱ 50,000.00 or more to file a statement of assets, liabilities and net worth.

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Coverage and immunity. The decree called for the voluntary disclosure of correct taxable income, deductions and exemptions for taxable year 1974 to 1979 by *individual* taxpayers. Juridical persons were not included. It did not also apply to the usual exceptions such as those with pending civil and criminal cases involving tax liabilities. The usual immunities and privileges granted to the qualified amnesty taxpayer were adopted. A provision, however, was provided to the effect that *except for internal revenue tax purposes*, it was unlawful to disclose any information as regards the amnesty return or the statement of assets, liabilities and net worth. The same law provided that one who is subsequently found to have wilfully filed a false or fraudulent original or amended return shall be subject to penalty. The same was true in the case of failure to file or fraudulent filing of the statement of assets and liabilities.

Conditions. The tax payable under this amnesty law was supposed to be the same tax due and called for under existing income tax law during the years covered, but the amnesty taxpayer was required to file his correct income, deductions, and exemptions. Taxes already paid during the years covered were deductible or creditable from the correct tax due as reflected and determined in the amnesty tax return. Filing of the statement of assets and liabilities was required. Finally, it was further required that the taxable income declared under this amnesty decree should not be understated to the extent of 25% or more of the correct net taxable income.

6. Presidential Decree No. 1840, issued 19 September 1981

One year after, the last amnesty decree was issued by former President Marcos. The decree justified that ". . . on account of the relatively complicated manner of computing the tax to be paid under PD No. 1740, only a limited number of taxpayers have availed themselves of the benefits of the said decree despite the grant of immunity from investigation" and that ". . . it is the desire to afford full opportunity for individual taxpayers to come within the fold of the tax reforms and to provide them with a clean start for the adoption of the gross income taxation scheme".

Coverage and immunity. This amnesty included not only previously untaxed income, but also gifts, bequests and any other acquisitions. The taxable years covered were from 1974 to 1980. The usual exceptions were provided as well as the same immunities and privileges granted under PD 1740. The limitations so provided under the same PD 1740 was incorporated making the amnesty taxpayer subject to investigation and penalty in case of fraudulent filing of the statement of assets, liabilities and net worth.

Conditions. The amnesty tax was pegged at 20% in the case of resident citizens and resident aliens and 2% in the case of non-resident citizens with respect to income derived from sources outside the Philippines. The amnesty tax should not, however, be lower than ₱ 1,000.00 for each taxable year wherein an amnesty return was filed. Specific dates for filing the statement and amnesty return as well as the payment of the tax were indicated.

B. Other tax amnesties

1. On untaxed or improperly taxed motor vehicles

Presidential Decree No. 52, issued 16 November 1972, granted amnesty to owners or possessors of untaxed or improperly taxed motor vehicles. A 50% deduction on the amount of the tax due on motor vehicles with year models 1970 to 1972 and 70% deduction on the amount of the tax due on motor vehicles with year models 1969 and below were granted to those who availed themselves of the amnesty.

2. On untaxed or improperly taxed goods

Presidential Decree No. 53, 16 November 1972, granted a tax amnesty to owners or possessors of untaxed or improperly taxed goods. Under this decree, importers, dealers, possessors or owners of items, commodities, goods, articles or merchandise, the taxes, duties or charges on which had not been paid or were not correctly paid were required to submit a true inventory of such goods, commodities or articles. Persons availing were not asked any question as to the origin of the goods, etc. These persons were only asked to pay 25% across-the-board tax on or before 31 January 1973. The amnesty taxpayer was relieved of the penalties attached under existing Philippine laws.

3. On delinquent tax accounts and contested Internal Revenue Assessments

Presidential Decree No. 68, issued 24 November 1972, afforded taxpayers with delinquent accounts and pending contested tax cases the opportunity to settle their tax obligations without civil, criminal or administrative liability. The decree condoned all delinquent tax accounts as of 24 November 1972 amounting to ₱ 100.00 or less. The same decree allowed the taxpayers to settle their tax obligations by paying such delinquent accounts reduced by 40% if payment was made on or before 31 January 1973 or 20% if payment was made on or before 28 February 1973.

4. On non-filers of income tax returns

Presidential Decree No. 213, issued 16 June 1973, granted tax amnesty to any person who was not liable to pay the income tax, but who was nevertheless required by law to file a tax return, however, he had failed to do so, and to any person liable to pay the income tax, but who failed to file the corresponding tax return and to pay the tax due thereon. The decree provided that tax filers availing of the amnesty should voluntarily file a return for each of the taxable years when no return was filed and to pay ₱ 10.00 for each taxable year. If any return so filed showed some tax due, they should also pay 20% of such amount. Tax filers were given the same immunity granted under the first income tax amnesty decree, i.e., PD No. 23.

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III. TAX AMNESTIES UNDER PRESIDENT CORAZON C. AQUINO

A. On untaxed income

Under Executive Order (E.O.) No. 41, issued 22 August 1986, President Aquino declared a "one-time tax amnesty covering unpaid income taxes for the years 1981 to 1985". The income tax amnesty raised the following objectives among others: (a) to generate more revenues, and (b) to impress upon the taxpayers that after this one-time tax amnesty, Government will vigorously enforce existing tax laws. This also gives taxpayers the chance to start anew under the Aquino Government.

Coverage. As noted, the amnesty covered only unpaid income taxes for the years 1981 to 1985. It is available to natural or juridical persons. This income tax amnesty is not, however, available to the following:

(a) Former President Marcos, Imelda Marcos, their immediate family, relatives, subordinates, business associates, dummies, agents or nominees as well as those falling under the jurisdiction of the Presidential Commission on Good Government;[13]
(b) Those with pending tax cases before the Bureau of Internal Revenue and before the courts;
(c) Those with pending cases involving unexplained or unlawfully acquired wealth before the Sandiganbayan;[14]
(d) Those who have withholding tax liabilities insofar as said liabilities are concerned; and
(e) Those liable for the felonies of frauds, illegal exactions and transactions, malversation of public funds and property under the Revised Penal Code.

Immunities and privileges. A taxpayer who avails himself of the tax amnesty shall enjoy the following immunities and privileges:

(a) Extinguishment of civil, criminal and administrative liabilities arising from the non-payment of income taxes due from 1 January 1981 to 31 December 1985;
(b) Inadmissibility in evidence of the taxpayer's tax amnesty declaration in all proceedings in which he is defendant or respondent and such return shall not be looked into, examined or inquired by any person, Government official, bureau or office; and
(c) The books of account and other records of the taxpayer from 1 January 1981 to 31 December 1985 shall not be examined for income tax purposes, except when same taxpayer claims a tax refund, credit, incentive and/or exemption in which case the BIR Commissioner may authorize in writing the examination of such documents.

Conditions. On or before 31 October 1986, the interested amnesty taxpayer should (a) file his statement of net worth as of 31 December 1980 and as of 31 December 1985 and (b) pay the amnesty tax equivalent to 10% of the increase in net worth from 31 December 1980 to 31 December 1985 but which tax should not be lower than ₱ 5,000.00 for individuals and ₱ 10,000.00 for juridical persons.

B. Other tax amnesties

1. On delinquent real property taxes

Under Executive Order No. 42, issued 22 August 1986, President Aquino likewise proclaimed a "one-time real property tax amnesty".

This covered real property taxpayers who are delinquent in the payment of real property taxes payable as of 31 December 1985. The amnesty can be availed of until 31 December 1986. Fifty percent of the accumulated delinquent real property taxes and the entire amount of penalties as of 31 December 1985 shall be condoned. This means that the delinquent taxpayer shall only pay, under the amnesty, 50% of the total taxes due.

2. On disputed Internal Revenue tax assessments

Executive Order No. 44, issued 4 September 1986, allowed taxpayers with disputed assessments to settle their tax obligations by paying 30% of the assessed amount. In complying with the requirements, the taxpayer shall be relieved of the penalties and liabilities attached thereto.

IV. ASSESSMENT AND OBSERVATIONS

A. On the tax amnesties under Marcos Era

The almost yearly recurrence of tax amnesty issuances under the Marcos regime was not really premeditated. As noted earlier, the overriding motive for the grant of tax amnesty after the declaration of martial law was to enable errant taxpayers to reform themselves and to join the efforts of the New Society. Due perhaps to the initial success of the first amnesty tax law (PD 23) in terms of taxpayers' response, Government was moved to extend the effectivity and expand the coverage thereof. Of course, subsequent tax amnesties did not result in comparable tax revenues (see Table 1) as the first one. However, there were inherent beneficial effects that were felt pursuant to the tax amnesty grants. These include the generation of otherwise uncollectible or difficult to recoup tax revenues and the easing of administrative tax backlogs. At the same time, Government was gradually being able to maintain a taxpayers' inventory which could help, to the extent permissible, in future tax enforcement efforts.

Of course, there were also unfavourable feedbacks and results. Taxpayers later got use to amnesty issuances thereby somehow impairing tax compliance. It was not then unusual to hear taxpayers being induced not to pay correct tax obligations because they were waiting for subsequent tax amnesty in the offing.

13. Under Executive Order No. 1 (dated 28 February 1986), the Presidential Commission on Good Government (PCGG) was created and tasked with the recovery of ill-gotten wealth by President Marcos and his alleged cronies.
14. "Sandiganbayan" is a special court which adjudicates cases involving graft and corruption by public officials.

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On the other hand, those who were religiously paying their taxes were complaining for they were being clearly unfairly treated by Government. They felt that they were duped into complying with their tax responsibilities. The sanctions provided for by law became dead provisions which Government were not intent to sincerely pursue. This was ironical because the Philippines was supposed to be under martial law, but instead of punishment, the tax evader received immunity practically from 1980 (last amnesty coverage) down to 1971 and prior years (first amnesty coverage). It covered the entire martial law period. Evidently, this affected the credibility of Government and its tax enforcement arm in the task of tax collection.

Revenue generated. The immediate, significant and concrete achievement of the tax amnesties under the previous regime was the substantial amount of tax revenues that poured into Government treasury under the first two laws. Table 1 shows that the 10 tax amnesty decrees generated a total of approximately ₱ 1.9 billion with the 6 tax amnesties on untaxed income or wealth contributing 96% and the remaining 4 adding a measly 4%. Such amounts were viewed as sure increase in revenue collection for those years covered. It is doubtful whether Government could be able to recoup such amounts through its ordinary tax enforcement efforts of surveillance, investigation, scrutiny and even judicial litigation.

Table 1
Total amnesty tax filers and revenue collected
(In million pesos)

Decree No./Nature	*No. of filers*	*Revenues*
A. On Untaxed Income/Wealth		
1. PD 23	143,985	732.80
2. PD 157	69,521	393.65
3. PD 370	59,955	202.59
4. PD 631	106,944	105.00
5. PD 1740 & PD 1840	92,808	378.1
TOTAL	473,213	1,812.14
B. Others		
1. PD 52 (motor vehicles)	4,273	16.76
2. PD 53 (goods)	850	2.94
3. PD 68 (delinquent accounts)	12,254	17.42
4. PD 213 (non-filers of income tax returns)	2,147,138	34.93
TOTAL	2,164,515	72.05
GRAND TOTAL	2,637,728	1,884.19

Source: BIR Annual Reports

Broadened taxable base. Based on the revenue generated, the tax amnesties broadened the taxable bases of the amnesty taxes, particularly the income tax. Coming to the folds of law and reporting what before were not being declared meant broadening the tax bases. With 143,985 taxpayers in 1972 and 92,808 taxpayers in 1981 who availed of the first and last major tax amnesties, it will not be highly speculative to expect an enlarging tax base for income. Total income tax revenues amounted to ₱ 1.9 billion which means that at least about ₱ 19 billion taxable income (at 10% tax) were never reported for the years covered. If 10% of this undeclared amount were to be regularly declared thereafter, then aggregate income of tax filers would annually increase by at least ₱ 1.9 billion.[15]

Improvement of tax consciousness. The ratio of taxpayers who availed themselves of the amnesty to total taxable filers can be gleaned from Table 2.

Table 2
Ratio of amnesty tax filers to total taxable filers

		Amnesty tax filers (a)	Total taxable filers (b)	Ratio of (a) to (b)
1. PD 23	Ind.	135,065		
	Corp.	8,920		
2. PD 157	Ind.	63,348	578,996	11.0%
	Corp.	6,073	8,165	74.4%
3. PD 370		59,955	587,161	10.2%
4. PD 631		106,944	755,032	14.2%
5. PD 1740 & PD 1840		92,808	893,842	10.4%

Sources of raw data: BIR Annual Reports
NTRC Papers

If the foregoing ratios on tax filers could be an indication of generated tax consciousness among the citizenry, it appears that in 1973 and then in 1980, the extent of tax evasion or fraudulent filing of income tax returns decreased by a few percentages. (This observation will be limited by the fact that the scope of the amnesty grant varied as to the years covered.) Notable, however, is the fact that the number of individual and corporate tax filers increased by about 78,393 or 13% from taxable years 1972 to taxable year 1973, after the first tax amnesty; by about 79,417 or 12% from taxable year 1973 to taxable year 1974, after the second tax amnesty; and by about 206,042 or 22% from taxable year 1981 to taxable year 1982, after the last tax amnesty decree. The number of income tax filers and revenues generated therefrom is presented in Table 3 below.

Finally, the best evidence of tax consciousness generated by the previous regime through tax amnesty is the effect of PD 213 issued in 1973 which granted an amnesty to taxpayers who failed to file income tax returns. More than 2 million availed themselves of the amnesty which means that approximately the same number of people could be expected to have complied with the requirement of law in subsequent years as regards tax filing. Unfortunately, this was not realized all through the years thereafter. As could be gleaned from Table 3, showing the regular annual income tax collections, the number of individual tax filers declined for the years 1980, 1983 and 1984 and that of corporate tax filers even declined for the years 1975, 1981, 1983 and 1984. Significantly, however, individual tax filers increased annually from 1972 to 1979. As a whole, the average yearly increase in total income tax collection was ₱ 964.95 million or 21%.

15. Except for 1975, total income tax collections were the uptrend (See Table 3).

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Table 3
Total income tax filers and revenues generated
(In million pesos)

Year	Individuals		Corporations		Totals		Average Increase %
	Number of filers	Amount	Number of filers	Amount	Number of filers	Amount	
1972	572,517	508.3	15,746	867.1	588,263	1,375.4	—
1973	648,538	520.6	18,027	1,857.7	666,656	2,378.3	73
1974	744,943	808.1	19,130	2,372.0	746,073	3,180.1	34
1975	883,001	1,119.7	10,841	1,954.1	893,842	3,073.8	–3
1976	1,025,692	1,483.0	13,288	2,222.2	1,038,980	3,705.2	20
1977	1,113,673	2,473.3	13,703	2,048.6	1,127,376	4,521.9	22
1978	1,383,001	2,548.8	14,421	2,641.6	1,397,422	5,190.4	15
1979	1,343,250	3,185.0	15,895	2,872.3	1,359,145	6,057.3	17
1980	861,882	3,289.0	16,057	3,331.9	877,939	6,620.9	9
1981	919,548	3,466.8	15,174	3,605.4	934,722	7,072.2	7
1982	1,124,022	3,355.0	16,742	3,961.3	1,140,764	7,316.3	3
1983	806,183	3,624.7	16,057	4,799.2	822,240	8,423.9	15
1984	707,921	4,369.5	12,662	8,208.2	720,583	12,577.7	49
1985	*	5,480.4	*	8,439.3	*	13,919.7	11
Totals	—	36,232.2	—	49,180.9	—	85,413.1	

* Data not yet available.

Basic Source: Annual Reports of the Bureau of Internal Revenue

Improvement in public morale. While this may not be accurately measured vis-à-vis the total impact of the tax amnesty, it may be safely deduced that the amnesty objective of allowing incorrigible taxpayers to start a clean slate should suffice to elevate public morale to a higher level. Of course, the problem crops up during the subsequent years when several amnesties had been enacted which could have neutralized the inherent objective of a tax amnesty.

On the negative side, the Marcos regime after the first two PDs, seemed to have considered tax amnesty as a regular source of revenue. This was also an acceptance that the tax administration machinery cannot cope with the situation. It was also an acceptance that tax evasion has accelerated as a practice.

B. Tax amnesties under President Aquino

Executive Order No. 41 is entitled "Declaring a One-Time Tax Amnesty Covering Unpaid Income Taxes for the Years 1981 to 1985". It will be recalled that the income tax amnesties of Marcos covered 1980 and prior years. The objectives of Executive Order No. 41 are: (a) to raise more revenues, and (b) to impress upon taxpayers that after this one-time income tax amnesty, Government will vigorously enforce existing tax laws.

The objective of generating more revenue hinges on the premise that taxpayers would come out voluntarily. While it seems instinctive to evade payment of taxes, for some people other factors could have motivated them to ignore or fraudulently comply with their tax obligations. The incumbent leadership was in the forefront in discrediting the Marcos administration for the alleged misuse of public money and rampant graft and corruption. This campaign emboldened taxpayers to rally behind the *civil disobedience campaign* of President Aquino which included non-payment or incorrect payment of taxes. Now that the discredited regime has been dislodged, the present dispensation in offering a tax amnesty gives the same taxpayers the opportunity to redeem their lost patriotism. But being one-time, Government is giving the warning that no other income tax amnesties are to be expected at least during this Government's incumbency. Thereafter, the entire tax enforcement mechanism will be utilized to generate maximum compliance among the citizenry.

The amnesty tax under E.O. No. 41 shall be 10% of the increase in net worth of the taxpayer from 31 December 1980 to 31 December 1985, but should not be lower than ₱ 5,000 for individuals and ₱ 10,000 for corporations. By adopting this net worth approach, Government is giving a compromise to the taxpayer whose presumed deficiency taxes amount to 10% thereof.

As regards the exceptions to the coverage of the tax amnesty, which were also present in the Marcos amnesty decrees, there are basic considerations for their non-inclusion. The non-inclusion of administrative, civil or criminal cases involving non-payment or fraudulent payment of income taxes is based on the traditionally accepted tenet of separation of powers. Once a case has been recognized by the judiciary or quasi-judicial bodies, the legislature should no longer approach that case. Besides, Government has already

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spent time, money and effort in the investigation and prosecution stages of these cases.

The same may be said as regards former President Marcos (and his associates) who have been subjected to investigation and prosecution through the Presidential Commission on Good Government created by President Aquino to recover illegally acquired wealth by Marcos and his men. With respect to withholding tax liabilities, the same should not really be subject to any kind of condonation because such liabilities involve tax money paid by people other than the withholding agent. It will be obnoxious to sound public policy if such withholding agents will be condoned for their acts of non-remittance of tax money they are entrusted with and mandated to remit thereafter to Government.

As regards the immunities condoned, the Executive Order is clear that it only condones tax related liabilities. With respect to liabilities involving non-payment of other taxes, E.O. 41 does not offer any amnesty; the same is covered by the other amnesties, e.g., E.O. 42 on real property liabilities, E.O. 44 on disputed assessments and another on foreign exchange stashed abroad. As regards cases which are not tax-related, the taxpayer can only invoke freedom from investigation and non-admission as evidence of the income tax amnesty return. The BIR Commissioner, however, could look into the books and records of the taxpayer in case the latter waives immunity from examination by asking for a tax refund, credit or incentive. Practical necessity requires their verification by tax authorities before a refund, credit or incentive is to be granted.

The rationale and implications of the other tax amnesties are more or less similar with Executive Order No. 41 and shall not be discussed in detail. From all these tax amnesty laws, Government is expected to raise about ₱ 1.040 million as revenues.[16]

Executive Order Nos. 41 and 42 were issued on 22 August 1986 or two months after the Tax Package was approved by the President and the Cabinet. Since only 4 months are left for taxpayers to avail themselves of the amnesties, there is need for the Government to undertake a vigorous nation-wide information campaign and promote the merits of the laws as widely as possible.

In the case of E.O. 41, two possible problem areas would concern the issue of double taxation and the short period of availment earlier mentioned. Since increase in net worth is the taxable base, there may be assets which might have been derived from income already declared and taxed that would be taxed again. Likewise, some assets might have been received through inheritance and donations on which transfer taxes might have been already paid. There may indeed be a point in allowing as credit (against the tax based on net worth) income taxes and possibly transfer taxes paid from 1981 to 1985.

Property Tax Amnesty under E.O. 42 presents three possible problems, these are: (1) possible confusion as to the basis of the computation of tax liabilities – 1978 or 1984 general revision; (2) the computation of delinquency regarding the special education tax may consider the ₱ 5,000 exemption under PD 1621 or ₱ 1,000 under PD 1913; and (3) the period covered may be 1985 and prior years and not 1981 to 1985.

It appears that there is an immediate need to inform the local treasurers of the laws and developments directly affecting property taxation. Clarifications especially on the problems just cited are also in order to avoid conflicts and delay in the payment and collection of tax liabilities. It is imperative that these problems are given priority considering that the availment of amnesty ends on 31 December 1986.

V. SUMMARY AND CONCLUSION

In the Philippines, a tax amnesty has been recognized as a significant innovation to attain certain objectives in tax administration such as generating public tax consciousness and recouping uncollectible tax revenues.

During the time of former President Marcos, about 2.6 million taxpayers availed themselves of tax amnesties and paid about ₱ 1.9 billion as amnesty taxes. Of the 10 tax decrees, 6 pertain to previously untaxed income and/or wealth which generated about ₱ 1.8 billion paid by 473,213 taxpayers. The response to the first amnesty decree was significant. Subsequent amnesty decrees on previously untaxed income did not generate much income. This shows that the number of errant taxpayers was probably decreasing as could be gleaned by the number of amnesty tax filers in 1972 to 1974. However, in 1975, the number of amnesty tax filers again increased (from 59,955 to 106,944). This was probably due to the announcement that the amnesty decree was supposed to be the last amnesty decree. After 5 years in 1980, a total of 92,808 amnesty tax filers was recorded showing that many taxpayers had been annually misdeclaring their taxable incomes. With such trend, and if some of its weaknesses are corrected, the Aquino income tax amnesty legislations are expected to generate considerable revenue upon noting that the taxable years covered are from 1981 to 1985 when the Marcos regime appeared to have been in serious political "credibility" crisis. The same may be said of the other tax amnesties issued by President Aquino.

While the income generated under the Marcos amnesty laws seems to be enough justification for their issuance, there is equal feeling that such amnesties seriously eroded the confidence of taxpayers in Government. The level of tax consciousness could have been seriously affected by the almost yearly issuance of tax amnesty laws which undermined the efforts of tax enforcement agencies. It seems that the Government has regarded tax amnesty as a regular tax source.

Despite the foregoing, the Aquino Government still

16. Excluding the proposed tax amnesty on repatriation of foreign assets.

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ventured on issuing its own versions of tax amnesty. The difference, however, is that the Aquino amnesties make clear the point that they are being issued as *first and last* during the Aquino incumbency. There is need for an amnesty grant because taxpayers were encouraged by the new Government not to pay their taxes as a form of civil disobedience during the Marcos regime, particularly for the period 1981 to 1985. An amnesty tax is considered proper at this point in time when the Philippines experiences a change of Government and political leaders. The amnesty legislation is also consistent with the call of President Aquino for a reconciliation between Government and the taxpaying public. Of course, revenues that may be generated will be of much help to the new regime as it undertakes its program of political, social and economic recovery. In fact, four months after Executive Order 41 was issued, availment of the Aquino Amnesty Law has already attained the goal of one billion pesos, despite of some basic weaknesses in the Law.

JOINT MEETING OF BRITISH AND SWISS BRANCHES

On 21 and 22 May 1987 the British and Swiss branches of IFA will meet in Lucerne (Switzerland). The purpose of this joint meeting is:
- to obtain a better knowledge of the tax system of the other country;
- to further the understanding of problems connected with cross-border transactions; and
- the discussion (in English) of various tax problems with colleagues.

The following subjects have been listed:

1. Selected topics:

United Kingdom: Advance Corporation Tax (ACT); Value Added Tax (VAT).
Switzerland: Federal tax system; lump sum taxation; trusts; stamp taxes.

Papers will be read by:
- Michael Smart, Group Tax Manager, Rank Xerox Ltd., London;
- John Reynolds, Group Tax Manager, Royal Bank of Scotland, London; and
- Dr. Marcus Desac, Rechtsanwalt, Büro Pestalozzi & Gmür, Zürich.

2. Base companies:

United Kingdom: Corporate residence; non-resident U.K. companies; Controlled Foreign Corporation provisions (CFC).
Switzerland: Cantonal tax privileges.

Papers will be read by:
- Bernard Jeffcote, International Tax Partner, Arthur Young, London;
- David Ross, International Tax Partner, Price Waterhouse, London; and
- Gion Clopath, Partner, Peat Marwick Mitchell & Co., Geneva.

The discussions will be chaired by Dr. Jürg Plattner, Büro Stiffler & Nater, Zürich.

3. Abuse of tax treaties

Anti-abuse provisions in national and tax treaty law; possibilities of tax planning.

Papers will be read by:
- Eric Tomsett, International Tax Partner, Touche Ross, London; and
- Gérard Menétry, Wissenschaftlicher Adjunkt, Division for international tax law and double taxation matters, Federal Tax Administration, Bern.

The discussions will be chaired by Lionel Halpern, Group Tax Manager, Glaxo Holdings Plc., London.

4. Disguised dividend distributions

The determination of transfer prices, inclusive secondary profit adjustments; tax problems connected with the purchase of enterprises in other countries and merger operations.

Papers will be read by:
- Ken Etherington, Group Tax Manager, British-American Tobacco Company Plc., London; and
- Dr. Peter Altenburger, Rechtsanwalt, Büro Stucki & Altenburger, Zürich.

The discussions will be chaired by Hugh Roe, Tax Director, Imperial Chemical Industries Plc., London.

5. Current international tax problems

A panel discussion will be held on mutual assistance in tax matters between the tax administrations of two countries and the exterritorial application of domestic law. This panel will consist of Malcolm Penney, Tax Partner, Dearden Farrow, London and Daniel Lüthi, Vice Director of the Division for international tax law and double taxation matters of the Federal Tax Administration, and chaired by prof. Dr. W. Ryser, Direktor ATAG Allgemeine Treuhand AG, Bern. AG, Bern.

Registration is possible up to 6 May 1987. The address of the conference organization is:
IFA Sekretariat
c/o Schweiz. Bankgesellschaft/Steuerdienst, Bahnhofstrasse 45
8021 Zürich, Switzerland
Phone 01/234 23 78

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CZECHOSLOVAKIA:

Conventions on the Avoidance of Double Taxation

By Milan Bakeš

This article is intended to provide a concise review of the principal rules governing the taxation of non-residents and the Conventions for the avoidance of double taxation concluded by the Czechoslovak Socialist Republic.

TAXATION OF INCOME IN CZECHOSLOVAKIA

Under the Czechoslovak fiscal legislation, all categories of income or profits are subject to tax regardless of how, or where, the income is acquired, whether it is regular or casual, whether it is saved, invested or consumed.

Since 1 January 1983, no tax on capital has been levied.

Residents and non-residents

Taxation laws make a distinction between taxation of residents and taxation of non-residents.

An individual is deemed to be a resident of Czechoslovakia if he has a permanent home available to him in Czechoslovakia or if he is present in that country for more than one year.

A legal person is deemed to be a resident of Czechoslovakia if it is established under the Czechoslovak law or if it has its statutory seat or place of management in Czechoslovakia.

All other natural and legal persons are deemed to be non-residents.

Taxation of residents

Residents are subject to unlimited tax liability, i.e. they are taxed on all their income originating in Czechoslovakia as well as abroad (world-wide income). Czechoslovak citizens sent abroad in the service of the Czechoslovak Government (e.g. diplomatic agents and consular officers) are also subject to full tax liability.

Taxation of non-residents

Non-residents are subject to tax on income derived from Czechoslovak sources (limited tax liability).

The following types of income are, for instance, deemed to be derived from Czechoslovak sources:

(1) Income from immovable property situated in Czechoslovakia.
(2) Business profits coming from a permanent establishment situated in Czechoslovakia (only profits attributable to the permanent establishment are taxed).
(3) Net profits distributed by a mixed company (joint venture) to the shareholders.
(4) Interest and royalties paid by Czechoslovak debtors.
(5) Remuneration paid for independent or dependent personal services exercised in Czechoslovakia.
(6) Income derived by public entertainers, musicians and athletes from their personal activities as such exercised in Czechoslovakia.

The members of diplomatic missions and consular posts enjoy fiscal privileges according to the provisions of the Vienna Conventions.

Professor Dr. Milan Bakeš (Juris Doctor, Candidatus Scientiae) was born on 11 October 1939 in Žamberk, Czechoslovakia. Educated at the grammar school in Rychnov nad Kněžnou, he was admitted to the Law Faculty of the Charles University in Prague where he completed his studies in 1961. After three years in the foreign exchange and legal department of a foreign trade enterprise, he won a competition for fellowship in the financial law department of the Law Faculty of the Charles University. Admitted as a lecturer, in 1969 he was appointed Assistant Professor of Financial Law.
In addition to some fifty papers on budget, taxation, credit and exchange problems published in Czechoslovakia and abroad, he has written five monographs. Among the more recent ones is the financial law textbook for Czechoslovak universities "Československé finanční právo" (Czechoslovak Financial Law).
Presently he is Professor of Financial Law and Pro-Dean of the Law Faculty of Charles University. He is also correspondent for *Tax News Service.*

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Concessions or exemptions given to non-residents

Some exemptions from the limited tax liability or concessions are accorded to non-residents.

Wages, salaries and similar remuneration derived from dependent personal services (employment) exercised in Czechoslovakia are exempt from tax if:

(a) the recipient is present in Czechoslovakia for a period or periods not exceeding in the aggregate 183 days in a calendar year, and
(b) the remuneration is paid by or on behalf of an employer who is not a resident of Czechoslovakia, and
(c) the remuneration is not borne by a permanent establishment situated in Czechoslovakia.

If the employment is exercised in Czechoslovakia and both the employer and employee are not residents of Czechoslovakia, 15% of the remuneration is exempt from tax and the tax is levied on the rest at the rate of 20%.

Business profits coming from a building site or construction project are exempt from tax if the building site or construction project does not last for more than 183 days.

Non-resident individuals cannot claim any personal allowances, reliefs or reductions for taxation purposes on account of civil status or family responsibilities which are granted to resident individuals.

Collection of the tax

The tax on wages, salaries and similar remuneration, if the wage, salary or similar remuneration is paid by an employer who is a resident of Czechoslovakia or the employment is exercised in a permanent establishment, is withheld at source. In other cases the tax is assessed on the yearly income. The tax on interest and on both industrial and cultural royalties is also withheld at source.

The tax on other income (e.g. income from business activities carried on in Czechoslovakia through a permanent establishment) is assessed. The payments made by Czechoslovak debtors to non-residents are subject to a prepayment of the tax (if the income is not subject to a withholding tax). The payer must withhold 5% of the amount paid and transfer it to the Tax Administration. The prepayments are credited against the taxpayer's final tax, and only the difference remains to be paid. If the prepayments exceed the final tax assessed, the excess is refunded to the taxpayer.

DOUBLE TAXATION

The application of both the residence principle and the source principle in Czechoslovakia and in other countries results in double taxation, the effects of which are harmful to the exchange of goods, technology and services and to the development of international economic cooperation.

In order to avoid double taxation, Czechoslovakia has concluded two multilateral Conventions with the States of the Council of Mutual Economic Assistance (CMEA) and several bilateral Conventions for the avoidance of double taxation.

MULTILATERAL CONVENTIONS

The Czechoslovak Socialist Republic, Bulgarian People's Republic, German Democratic Republic, Hungarian People's Republic, Mongolian People's Republic, Polish People's Republic, Romanian Socialist Republic and Union of the Soviet Socialist Republics are Member States of the Multilateral Convention for the avoidance of double taxation of income and of capital of individuals and of the analogous Convention concerning legal persons.

Convention for the avoidance of double taxation of income and of capital of individuals[1]

This Convention was signed in Miscolc on 27 May 1977. It entered into force on 1 January 1979 and has been effective since that date.

The Convention applies to natural persons who have a permanent abode in one of the Contracting States.

If the permanent abode (domicile) cannot be determined, the person is deemed to have his permanent abode in the Contracting State of which he is a national. If the question cannot be determined on the basis of nationality, the Ministries of Finance of the Contracting States settle the question by mutual agreement.

The Convention applies to taxes on income, capital, successions and gifts.

The Convention implies an allocation of the right to tax each individual item of income, capital, succession or gift between the State of residence (domicile) and the State of source (situs) according to the following provisions:

1. Residents of a Contracting State sent by an organ or an organization of this State to exercise employment in their commercial, transport or other agency including press and information centres, situated in any other Contracting State, are exempt in this other State from tax on the remuneration from this employment.

The same provision applies to residents of a Contracting State sent from this State to perform personal services in international non-economic organizations the statutory seat of which is situated in any other Contracting State.

2. Remuneration received for personal services by a resident of a Contracting State who is employed by an

1. For an English translation of the text, see 32 *Bulletin for International Fiscal Documentation* 9 (1978) at 411 and *Guides to European Taxation*, Vol. V, *Taxation in European Socialist Countries*, Section CMEA (hereafter cited as GET-V).

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international economic organization (e.g. a mixed company engaged in business) the statutory seat of which is situated in any other Contracting State may be taxed in this other Contracting State unless there is a special agreement between the Contracting States to the contrary.

3. Remuneration derived by a resident of a Contracting State in respect of personal services of technical or similar character, teaching, training or consultant services, lectures, personal activities of an entertainer such as a theatre, motion picture, radio or television artiste, or a musician, or an athlete, exercised in any other Contracting State, may be taxed in that other State if the remuneration is paid by a resident of that other State.

If the remuneration is paid by a resident of the first-mentioned State, the remuneration may be taxed only in this State.

4. Royalties of any kind received as a consideration for the use of any copyright of literary, artistic or scientific work, of any patent, scientific discovery, design or model, technical improvement, know-how, etc., may be taxed only in the Contracting State of which the recipient is a resident.

5. The immovable and movable property, income from use in any form of such a property, property acquired by inheritance, bequest or gift, gains from alienation of immovable or movable property are taxable in the Contracting State in which such a property is situated.

Convention for the avoidance of double taxation of income and of capital of legal persons[2]

This Convention was signed in Ulan Bator on 19 May 1978. It entered into force on 1 January 1979 and has been effective since that date.

The Convention applies to legal persons having their statutory seat in one of the Contracting States. If the seat of the legal person cannot be determined, the seat is deemed to be situated in the Contracting State, according to the law of which the legal person was established. If the seat of a legal person cannot be determined according to the above-mentioned provisions, the Ministries of Finance of the Contracting States shall settle the question by mutual agreement.

The Convention applies to taxes and other levies of similar character on income and on capital imposed in the Contracting States.

Subject to the provisions of the further paragraphs, the income of a legal person which is a resident of a Contracting State, originating in any of these States, received either directly or through a branch, agency, office or other similar facility, may be taxed only in the Contracting State of which the legal person is a resident.

The immovable property, income from the use of such property, gains from the alienation or from any other disposal of such property, may be taxed only in the Contracting State in which the property in question is situated.

The movable property, income from the use of such property, gains from the alienation or from any other form of disposal of such property, may be taxed only in the Contracting State of which the legal person is a resident.

Special agreements concluded by the Contracting States provide for taxation of income and capital of international organizations established by the Contracting States or of international economic organizations established by legal persons of those States.

Dividends paid by an international organization which has its seat in one of the Contracting States to its members are exempt from tax in this State if the recipient is a resident of any other Contracting State.

The provisions of this Convention shall not affect the fiscal privileges of diplomatic missions, consular posts, permanent missions or international organizations to which they are entitled under international law or under special agreements.

BILATERAL CONVENTIONS FOR THE AVOIDANCE OF DOUBLE TAXATION

Czechoslovakia has concluded Conventions for the avoidance of double taxation of income and capital with the States mentioned in Table 1.

Table 1

Contracting State	Date of signature	Convention applies to taxes on
Netherlands	4 March 1974	Income and capital
France	1 June 1973	Income and capital
Finland	31 January 1975	Income and capital
Belgium	19 June 1975	Income and capital
Japan	11 October 1977	Income
Austria	7 March 1978	Income and capital
Sri Lanka	26 July 1978	Income and capital
Norway	27 June 1979	Income and capital
Sweden	16 February 1979	Income and capital
Cyprus	15 April 1980	Income
Spain	8 May 1980	Income and capital
Denmark	5 May 1982	Income and capital
Yugoslavia	2 November 1981	Income and capital
Federal Republic of Germany	19 December 1980	Income and capital
Italy	5 May 1981	Income and capital

Conventions for the avoidance of double taxation not yet in force

The Conventions concluded by Czechoslovakia for the avoidance of double taxation with Morocco (signed 27

2. See Dr. Tibor Nagy, "Multilateral Tax Agreements and Tax Coordination in the CMEA" in 19 *European Taxation* 12 (1979) at 379. An English translation of the text is included in the Appendix at 387. See also GET-V, Section CMEA.

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June 1984), with India (signed 27 January 1986) and with Brazil (signed 26 August 1986) have not yet entered into force.

Czechoslovakia has also concluded several Conventions of a limited nature (shipping, air transport).

The bilateral Conventions for the avoidance of double taxation concluded by Czechoslovakia are based on principles adopted by the OECD Model Convention. There are, however, some departures from this Model Convention. In the Conventions concluded with developing countries more weight is given to the source principles than in the OECD Model Convention.

Allocation of the right to tax between the State of residence and the State of source in the bilateral Conventions concluded by Czechoslovakia

Table 2

Category of income or capital	Convention concluded with	The right to tax is conferred on (State of residence or State of source, situs, perm. establishment)
Immovable property, income from immovable property, gains from alienation of immovable property	All Contracting States	The Contracting State in which the immovable property is situated.
	Netherlands	Interest secured by mortgage on immovable property may be taxed in the Contracting State in which the property is situated.
Business profits	All Contracting States	State of enterprise.
Business profits made through a permanent establishment	All Contracting States	State in which the permanent establishment is situated. Only profits attributed to the permanent establishment are taxed. In some Conventions, the definition of "permanent establishment" departs somewhat from the wording of Art. 5 paragraph 3 of the OECD Model Convention.
Profits from shipping, inland water-ways and air transports	Belgium France Yugoslavia Netherlands FR Germany	The Contracting State in which the place of effective management of the enterprise is situated.
	Austria	State of the enterprise.
Profits from shipping and air transport	Denmark Finland Italy Cyprus Norway Spain Sweden	The Contracting State in which the place of effective management of the enterprise is situated.
	Japan	The State of the enterprise.
	Many agreements on air transport services contain provisions providing for the avoidance of double taxation of income and capital.	

Table 3

Category of income	Convention concluded with	The right to tax is conferred on (State of residence or State of source, situs, perm. establishment)
Dividends	All States	The right to tax is shared between the two Contracting States.
	Netherlands Sweden	The tax in the State of source must not exceed 10%. But if the recipient is a company which holds at least 25% of the capital of the company paying the dividends, the dividends may be taxed only in the State of residence.
	Finland Yugoslavia Norway Spain	The tax in the State of source must not exceed 15%. But if the recipient is a company which holds at least 25% of the capital of the company paying the dividends, the tax in the State of source may not exceed 5%.
	France Cyprus Austria	The tax in the State of source must not exceed 10%.
	Belgium Denmark Italy	In the State of source the tax must not exceed 15%.
	F.R. Germany	In the State of source the tax must not exceed 15%. But if the recipient is a company which holds at least 25% of the capital of the company paying the dividends, the tax in the State of source must not exceed 5%. When the rate for the distributed profits is lower at least by 20% than for undistributed profits, the tax in the State of source is 25%, if the recipient is a company holding at least 25% voting shares.
	Sri Lanka	Not more than 15% at source.
Interest	Finland France Denmark Italy Yugoslavia Norway F.R. Germany Austria Spain Sweden	The interest may be taxed only in the State of residence.
	Netherlands	The interest may be taxed only in the State of residence. But interest on debt-claims secured by mortgage are taxed as income from immovable property. Interest on debt-claims carrying a right to participate in the debtor's profits are taxed as dividends.
	Belgium	The right to tax is shared between the two Contracting States. The tax in the State of source may not exceed 10%. Interest on commercial loans, current accounts or deposits with a bank (except current accounts for securities) may be taxed only in the State of residence.
	Japan Cyprus Sri Lanka	The right to tax is shared between the two Contracting States. In the State of source, the tax may not exceed 10%. In the State of source, an exemption from tax is accorded to the Government credits.

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Category of income	Convention concluded with	The right to tax is conferred on (State of residence or State of source, situs, perm. establishment)
Royalties paid for the use of any patent, trade mark, design or model, plan, secret formula or process, know-how, equipment	Belgium Denmark Finland France Italy Cyprus Netherlands Norway F.R. Germany Austria Spain Sweden	The right to tax is shared between the two Contracting States, but the tax in the State of source may not exceed 5% of the gross amount of royalties.
–,,–	Japan Yugoslavia Sri Lanka	The right to tax is shared between the two States, but the tax in the State of source may not exceed 10% of the gross amount of royalties.
Cultural royalties (copyright)	Belgium Denmark Finland France Italy Japan Cyprus Norway Austria Spain Sweden Sri Lanka	Cultural royalties may be taxed only in the State of residence.
–,,–	F.R. Germany Netherlands	The right to tax is shared between the two Contracting States but in the State of source the tax may not exceed 5% of the gross amount of royalties.
	Yugoslavia	The right to tax is shared between the two Contracting States, but in the State of source the tax may not exceed 10% of the gross amount of royalties.

The other provisions of the Conventions concluded by Czechoslovakia for the avoidance of double taxation are either identical with or depart slightly from the OECD Model Convention.

REDUCTION OF OR EXEMPTION FROM THE CZECHOSLOVAK TAX

The non-residents who wish to benefit from tax exemption or tax reduction which they are entitled to claim according to the provisions of a Double Taxation Convention concluded by Czechoslovakia need not submit any application forms. In Czechoslovakia, the exemptions from the tax or reductions of the tax under provisions of a Convention for the avoidance of double taxation are accorded automatically at source.

There is, however, an exception for residents of Belgium who have to use application forms issued by the Belgian Fiscal Administration.

When the Czechoslovak debtor withheld the tax at variance with the provisions of a Double Taxation Convention or with internal law, the creditor may ask the Czechoslovak Financial Administration to refund the tax withheld or the difference between the amount of tax withheld and the amount of tax which could be withheld under the provisions of the Convention for the avoidance of double taxation. The application must be filed within 3 years since 1 January next following the date of the payment. No application form is prescribed. The application may be submitted by the intermediary of the Czechoslovak debtor.

UNILATERAL RELIEF FROM DOUBLE TAXATION

The residents of Czechoslovakia are entitled to the unilateral relief from double taxation under the Czechoslovak internal fiscal law if the income originates in a country with which Czechoslovakia has not concluded a Convention for the avoidance of double taxation.

Relief is granted provided the foreign tax is similar to Czechoslovak tax (corporation tax, tax on income, tax on profits). In other cases, foreign taxes paid are a deductible expense.

Originally, the exemption method was generally used in Czechoslovak internal taxation law. Since the latest changes in the taxation laws were introduced, the credit method has been used as a unilateral relief to eliminate double taxation of legal persons. As far as the agricultural tax on profits paid by enterprises and taxes on income paid by individuals are concerned, the exemption method has been used.

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HONG KONG:

Budget 1987

By I.W. Harris

Mr. Harris is Group Tax Adviser of The Hongkong and Shanghai Banking Corporation.

The new Financial Secretary, Mr. Piers Jacobs, presented his first budget on 25 February 1987.

He was able to present an optimistic picture with the forecast surplus of HK$ 348 million for 1986/1987 being raised to HK$ 3,077 million due mainly to buoyancy in tax revenue rather than any decrease in expenditure. However, despite the expected substantial surplus for 1986/87, the Financial Secretary proposed a cautious approach to 1987/88 by limiting growth in expenditure to 4.9% in real terms. Revenue was also expected to grow to produce an estimated surplus prior to taxation proposals of HK$ 2,093 million and after proposals the forecast surplus was reduced to HK$ 1,768 million. The principal amendments to taxation are as follows:

1. REVENUE RAISING MEASURES

The principal proposals to increase existing duties were:

- Motor spirit (gasoline) from HK$ 2.30 per litre to HK$ 2.40 per litre.
- Motor diesel from HK$ 1.15 per litre to HK$ 1.20 per litre.
- Hard liquor increases to range from 6% to 13%.
- Imported unmanufactured tobacco from HK$ 190 to HK$ 200 per kilogram.
- Cigars from HK$ 210 to HK$ 220 per kilogram.
- Chinese prepared tobacco from HK$ 40 to HK$ 43 per kilogram.
- Business registration fee from HK$ 500 to HK$ 550.
- Vehicle and driving licence fees increase around 5%.
- Visa and travel documents average increase of 12%.

2. TAX CONCESSIONS

A. Personal taxation

(i) Standard rate reduced from 17% to 16.5%.

(ii) Consolidation of the existing personal and additional allowance and creation of new additional personal allowances of HK$ 5,000 for a single person and HK$ 10,000 for a married person. The allowances for the first and second child are to be increased by HK$ 2,000 each. The new rates are therefore:

		1986/87 HK$	1987/88 HK$
Personal allowance	– single	20,500	29,000
	– married	41,000	60,000
Additional personal allowance			
	– single	8,500	5,000
	– married	19,000	10,000
Child allowances:	1st child	9,000	11,000
	2nd child	6,000	8,000

There will be clawback arrangements in respect of the additional personal allowances operating at HK$ 34,000 for a single person and HK$ 70,000 for a married couple.

(iii) The 15% band to be extended from HK$ 10,000 to HK$ 20,000. The new rate bands are therefore as follows:

	Tax HK$	Total HK$
First HK$ 10,000 @ 5%	500	500
Next HK$ 10,000 @ 10%	1,000	1,500
Next HK$ 20,000 @ 15%	3,000	4,500
Next HK$ 20,000 @ 20%	4,000	8,500
Balance @ 25%		

B. Profits tax

(i) Corporate rate reduced from 18.5% to 18%.

(ii) Standard rate reduced from 17% to 16.5%.

C. Estate duty

A reduction in the rates of estate duty as follows:

Where the principal value of the estate (in HK$)		Rate of estate duty 1987/88	1986/87
Does not exceed	2,000,000	Nil	Nil
Exceeds 2,000,000 but does not exceed	2,500,000	6%	10%
Exceeds 2,500,000 but does not exceed	3,000,000	8%	12%
Exceeds 3,000,000 but does not exceed	3,500,000	10%	14%
Exceeds 3,500,000 but does not exceed	4,000,000	12%	16%
Exceeds 4,000,000 but does not exceed	4,500,000	14%	18%
Exceeds 4,500,000 but does not exceed	5,000,000	16%	18%
Exceeds 5,000,000 and above	.....	18%	18%

3. LEGISLATIVE PROPOSALS

A. Time apportionment

It is proposed to introduce legislation to overcome a major area of dispute between the Revenue and the

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taxpayer where the taxpayer with a non-Hong Kong employment is only assessed for Hong Kong salaries tax on the basis of time spent in Hong Kong. Further, it is proposed to only grant time apportionment where the absence exceeds 60 days and, although it is not absolutely clear, it would appear that the new law will apply irrespective of whether the employment is Hong Kong or foreign.

B. Anti-avoidance

The Financial Secretary proposes to outlaw schemes based on the Australian Myer Emporium case whereby income flows are converted into a capital receipt.

C. Double taxation

Although no legislation is promised, the Financial Secretary has stated he will look into the question of double taxation particularly in relation to the People's Republic of China.

WESTERN SAMOA:

Budget 1987

By Fapiano Stowers*

Policy perspectives

The Government will continue to work towards creating a stable economic environment while at the same time accelerating the process of structural transformation of the economy which should serve to strengthen and diversify the capacity to produce and to export.

(i) *Fiscal policy*

Steps will be taken to maintain and strengthen the budgetary positions of the Government and public enterprises so that there is no undue burden of adjustment on monetary and credit policy instruments in the future. The main emphasis is on reducing as far as practicable the role of the Government and public enterprises in the economy.

The Government has already taken steps in this direction through the sale of its minority shareholdings in selected private companies, initiation of negotiations on the privatization of the Special Projects Development Corporation and the liquor operations of the Customs Department.

(ii) *Taxation policy*

The taxation policy of the Government focuses on the need to reduce and equitably distribute the overall tax burden and institute incentives for development. Progress on the reduction of the overall tax burden will depend to a large extent on the success in cutting back on the size of the Government expenditures. The Government, in pursuing a more equitable distribution of the tax burden, has taken the following actions:

(a) *Goods and services tax*

Introduction in the 1986 First Supplementary Estimates of a first stage of a broad based consumption tax in the form of a limited goods and services tax. It is intended that in time this tax will be expanded to cover all services, then, ultimately all goods. Such expansion will, however, be linked directly to reforms in the income tax, excise tax, and the customs tariff for which extensive reviews have already commenced, some of which are nearing completion.

It is not possible to implement only those policy issues which result in revenue reductions without the simultaneous introduction of new or expanded measures to offset these reductions.

(b) *Income tax reform*

The detailed revieuw of the income tax which has been taking place over the past two years is now nearing completion and a final draft act should be tabled in the 1987 Session of Parliament. In the meantime, the Government has approved of a reduction in income tax by proposing an interim reduction in taxes from 1 January 1987 until such time the new act is introduced.

Generally normal income tax for individuals will be reduced by 15% up to the level of $ 3,000 and by 10% on any excess over $ 3,000 tax. Company taxes will be decreased from 42% to 39% whereas taxes on dividends paid to residents will be increased to a final tax of 10%.

[continued on p. 190]

* Coopers and Lybrand, Matautu - uta, Western Samoa.

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SOUTH AFRICA:

The 1987 Mini-Budget

By Dr. Erwin Spiro, LL.D(h.c.)

1. INTRODUCTION

Because of the forthcoming election on 6 May 1987, the proper Budget will be submitted late this year. Following a precedent set in 1981, the Minister of Finance, Mr. Barend du Plessis, laid (provisional) taxation proposals upon the table in Parliament on 9 February 1987, in respect of the year of assessment ending on 29 February 1988 or 30 June 1988, whichever is applicable. The proposals are subject to the present law and the amending Act to be passed during the present session of Parliament. The proposals deal only with individual taxpayers and not with companies.

2. TABLES

The proposals contain the following tax tables for married persons and not married persons respectively.

TABLE FOR MARRIED PERSONS

Taxable income	Rates of tax
Where the taxable income–	
does not exceed R12,000	15% of each R1 of the taxable income;
exceeds R12,000 but does not exceed R13,000	R 1,800 plus 16% of the amount by which the taxable income exceeds R12,000;
exceeds R13,000 but does not exceed R14,000	R 1,960 plus 18% of the amount by which the taxable income exceeds R13,000;
exceeds R14,000 but does not exceed R15,000	R 2,140 plus 20% of the amount by which the taxable income exceeds R14,000;
exceeds R15,000 but does not exceed R16,000	R 2,340 plus 22% of the amount by which the taxable income exceeds R15,000;
exceeds R16,000 but does not exceed R18,000	R 2,560 plus 24% of the amount by which the taxable income exceeds R16,000;
exceeds R18,000 but does not exceed R20,000	R 3,040 plus 26% of the amount by which the taxable income exceeds R18,000;
exceeds R20,000 but does not exceed R22,000	R 3,560 plus 28% of the amount by which the taxable income exceeds R20,000;
exceeds R22,000 but does not exceed R24,000	R 4,120 plus 30% of the amount by which the taxable income exceeds R22,000;
exceeds R24,000 but does not exceed R26,000	R 4,720 plus 32% of the amount by which the taxable income exceeds R24,000;
exceeds R26,000 but does not exceed R28,000	R 5,360 plus 34% of the amount by which the taxable income exceeds R26,000;
exceeds R28,000 but does not exceed R30,000	R 6,040 plus 36% of the amount by which the taxable income exceeds R28,000;
exceeds R30,000 but does not exceed R35,000	R 6,760 plus 38% of the amount by which the taxable income exceeds R30,000;
exceeds R35,000 but does not exceed R40,000	R 8,660 plus 40% of the amount by which the taxable income exceeds R35,000;
exceeds R40,000 but does not exceed R45,000	R10,660 plus 42% of the amount by which the taxable income exceeds R40,000;
exceeds R45,000 but does not exceed R50,000	R12,760 plus 43% of the amount by which the taxable income exceeds R45,000;
exceeds R50,000 but does not exceed R60,000	R14,910 plus 44% of the amount by which the taxable income exceeds R50,000;
exceeds R60,000	R19,310 plus 45% of the amount by which the taxable income exceeds R60,000.

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TABLE FOR NOT MARRIED PERSONS

Taxable income	Rates of tax
Where the taxable income–	
does not exceed R10,000	15% of each R1 of the taxable income;
exceeds R10,000 but does not exceed R11,000	R 1,500 plus 16% of the amount by which the taxable income exceeds R10,000;
exceeds R11,000 but does not exceed R12,000	R 1,660 plus 18% of the amount by which the taxable income exceeds R11,000;
exceeds R12,000 but does not exceed R13,000	R 1,840 plus 20% of the amount by which the taxable income exceeds R12,000;
exceeds R13,000 but does not exceed R14,000	R 2,040 plus 22% of the amount by which the taxable income exceeds R13,000;
exceeds R14,000 but does not exceed R15,000	R 2,260 plus 24% of the amount by which the taxable income exceeds R14,000;
exceeds R15,000 but does not exceed R16,000	R 2,500 plus 26% of the amount by which the taxable income exceeds R15,000;
exceeds R16,000 but does not exceed R18,000	R 2,760 plus 28% of the amount by which the taxable income exceeds R16,000;
exceeds R18,000 but does not exceed R20,000	R 3,320 plus 30% of the amount by which the taxable income exceeds R18,000;
exceeds R20,000 but does not exceed R22,000	R 3,920 plus 32% of the amount by which the taxable income exceeds R20,000;
exceeds R22,000 but does not exceed R24,000	R 4,560 plus 34% of the amount by which the taxable income exceeds R22,000;
exceeds R24,000 but does not exceed R26,000	R 5,240 plus 36% of the amount by which the taxable income exceeds R24,000;
exceeds R26,000 but does not exceed R28,000	R 5,960 plus 38% of the amount by which the taxable income exceeds R26,000;
exceeds R28,000 but does not exceed R30,000	R 6,720 plus 40% of the amount by which the taxable income exceeds R28,000;
exceeds R30,000 but does not exceed R34,000	R 7,520 plus 42% of the amount by which the taxable income exceeds R30,000;
exceeds R34,000 but does not exceed R38,000	R 9,200 plus 43% of the amount by which the taxable income exceeds R34,000;
exceeds R38,000 but does not exceed R42,000	R10,920 plus 44% of the amount by which the taxable income exceeds R38,000;
exceeds R42,000	R12,680 plus 45% of the amount by which the taxable income exceeds R42,000.

As will be seen from these tables, the maximum rate of tax for married persons is reached with R60,000 and amounts to 45% (it was 50% less 5% discount = 47.5%); the maximum rate of tax for not married persons is reached with R42,000 and amounts also to 45% (against likewise 47.5%). The rate of tax starts now with 15% (it was 16% less 5% discount = 15.2%).

3. PRIMARY REBATES

Primary rebates will now be an amount of R920 – was R880 – in the case of a married person and R650 – was R620 – in the case of a person who is not a married person.

4. WORKING MARRIED COUPLES

The deduction which may be allowed to a taxpayer in whose income there is included any earnings of his wife is now an amount equal to the greater of R2,250 – was R1,800 – or 22.5% – was 20% – of the net earnings of his wife.

5. INCREASE OF TAX-FREE INTEREST

The Minister is also reported to have promised an increase of tax-free interest on savings from R500 to R1,000.

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Series on International Taxation, no. 7

Tax Coordination in the European Community

Professor S. Cnossen
Dean of the Economics Faculty of Erasmus University Rotterdam

"Tax Coordination in the European Community" contains 13 papers on a great variety of subjects, including tax structure developments, the harmonization of product taxes, taxes on motoring, the coordination of taxes on capital income and corporations, personal income taxes, and the interaction between fiscal and monetary policies. The views of leading overseas specialists and those of EC economists and lawyers should lead to further public and academic discussion of basic tax harmonization issues in the Community.

In separate chapters the contributors argue that border controls and customs posts can be abolished by shifting border tax adjustments for the value-added taxes to books of account. However, rate approximation is not essential. Furthermore, the Community-wide introduction of an excise system of suspension is required. Some tax convergence in the field of taxes on motor vehicles and fuel has occurred. The free movement of capital would be promoted through the adoption of a source-based, equal rate corporation tax applied to a uniformly defined base. If such a tax were adopted, the need for a uniformly applied imputation system would disappear. In view of the residence principle, the harmonization of taxes on labor income is less urgent. Efforts at tax harmonization may be undone if monetary policies are not coordinated.

Arguments are presented from the perspective that tax reform is an important, indispensable part of the tax coordination process, that diversity among tax systems, provided it does not interfere with the establishment of a true Community, is to be preferred to tax uniformity, that personal direct taxes should not be played down in favor of indirect taxes, and that tax harmonization should be viewed in the broader context of tax and expenditure coordination.

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[continued from p. 187]

The proposed adjustments are expected to result in a reduction in revenues from direct income taxes of $ 1.5 million which is considered the maximum reduction the 1987 Budget could afford without requiring some offsetting increases in other taxes.

(c) *Excise tax*

The Government also proposes to eliminate excise taxes on those domestically produced products which are produced almost entirely from local raw materials. The continuing overall review of all taxes will incorporate excise tax.

(d) *Pensions payable by NPF*

The Government is proposing that pensions payable by the National Provident Fund be exempted from income tax in 1987.

(e) *Customs tariff anomalies*

A proposal to correct several of the anomalies in the customs tariff rates was floored, although the customs tariffs are being reviewed as part of the overall customs tariff reform excercise.

(f) *Estate and Gift Duty Law*

The existence of this law has retarded development. It will be repealed as from 1 January 1987.

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To facilitate ordering, a list of addresses of the main publishing houses is included on pages 46-48 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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MAY 1987

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U.S.A. Branch of I.F.A., Att. Richard L. Goldman, Goldman & Gladstone, Suite 2150, 522 Fifth Avenue, New York, N.Y. 10036, U.S.A.

Zentrum für Unternehmungsführung AG, Schulstrasse 7, CH-8802 Kilchberg-Zürich, Switzerland.

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CANADA:

INTERNATIONAL TRANSFER PRICING AND OTHER INTERNATIONAL TRANSACTIONS

(Information Circular) *

Introduction

1. This circular is for the guidance of any Canadian taxpayer related to entities in one or more foreign jurisdictions. It applies to international non-arm's length transactions involving a Canadian taxpayer, and it describes the Department's approach to the tax treatment of international transfer pricing and other issues that have an effect on the income reported in Canada.

2. In basic terms the taxpayer in Canada is expected to report taxable income on the basis of having charged a fair price for goods and services provided to non-resident affiliates, and of having paid no more than a fair price for goods and services received from non-resident affiliates. In this latter connection, it must be emphasized that the taxpayer should not absorb any duplication in the inter-company prices and other charges that are incurred.

3. Although some of the comments that follow are made in the context of the transfer or goods or services *into* Canada, the principles apply equally to the reverse situation. This circular has been divided into three parts.

PART I
The law

A summary of the relevant provisions of the Income Tax Act and their scope of application to international, non-arm's length transactions; this summary is not to be construed as a formal interpretation of the law, but rather an explanation of the basis on which the Department considers that the "arm's length principle" is reflected in the Act.

PART II
Pricing methods and considerations

A discussion of some of the theories and principles of transfer pricing and some of the practical considerations in the application of the Income Tax Act to the transfer of goods and the various forms of transfer of services, e.g., management services, research and development and the use of intangibles.

PART III
Audit policy

A summary of the Department's policy on auditing international non-arm's length transactions.

PART I – THE LAW

4. Section 69 of the Income Tax Act applies, in part, to certain non-arm's length transactions, including those with which this circular is mainly concerned, namely, intercompany purchases and sales of goods and all manner of property; transfers of technology, rights, patents, and intangibles; the rental of property; the use of intellectual property, and the providing of technical assistance. Management fees and other payments for services are covered by these provisions as are payments resulting from research and development, cost-sharing arrangements or expense allocations. Other sections may be applicable in a particular case, including section 67 (which disallows unreasonable expenses) and subsection 245(1) (which deals with undue or artificial reductions of income), subsection 15(1) (shareholder appropriations) and Part XIII (tax on income from Canada of a non-resident).

5. Paragraphs 69(1)(a) and (b) apply to non-arm's length acquisitions and dispositions of "anything" which includes products and other tangibles as well as intangible property, such as a right to use property. Paragraph 69(1)(a) means in effect that for income tax purposes the cost of acquisition may not exceed fair market value, and paragraph 69(1)(b) means that the proceeds of disposition may not be less than fair market value. Although this circular deals with international non-arm's length transactions which are governed by the provisions of subsections 69(2) and 69(3), the Department uses the same theories and principles of transfer pricing to determine fair market value under subsection 69(1) for domestic non-arm's length transactions. This is further elaborated on in 7 below.

6. Subsections 69(2) and (3) override subsection 69(1) and apply if the transaction involves a Canadian taxpayer and a non-resident with whom the taxpayer was not dealing at arm's length. These provisions apply specifically to product prices, royalties, rentals, transportation charges and fees for other services. Subsection 69(2) means in effect that the amount that the taxpayer in Canada has paid or agreed to pay to the non-resident may not, for tax purposes, exceed a reasonable arm's length price, whereas subsection 69(3) effectively means that the amount (including a nil amount) a non-resident not dealing at arm's length

* Presented by Nathan Boidman, Esq., correspondent for the *Bulletin*.

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has paid or agreed to pay to a Canadian taxpayer may not, for tax purposes, be less than a reasonable arm's length price. It should be noted that these provisions are applied to each transaction.

7. 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 market share, the supplier 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).

8. Interet on loans and other indebtedness to or from non-residents will normally be subject to the specific provisions in paragraph 20(1)(c) and section 17 which provide for the deductibility of reasonable interest expenses and deal with situations whereby a Canadian corporate taxpayer has not charged an adequate rate of interest on a loan to a non-resident. Intercompany interest charges are not dealt with specifically in this circular, but it is recognized that credit terms and financing arrangements are among the many related factors to be considered in the evaluation of intercompany prices. (See 12 below).

PART II – PRICING METHODS AND CONSIDERATIONS

9. The "arm's length principle", in the context of transactions between parties that are not in fact dealing at arm's length, 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. In applying the arm's length principle, the Department endorses and follows the methods set out in the 1979 Organisation for Economic Co-Operation and Development ("OECD") report, "Transfer Pricing and Multinational Enterprises", with a strong preference for clearly defined and established intercompany arrangements.

10. To the extent possible, taxpayers are encouraged to design their intercompany pricing so that, for example, a product is transferred at a reasonable arm's length price for the product itself, and if there are also benefits or services being transferred, as is common in the operations of a multinational group, each is identified as a separate transfer and is subject to a separate evaluation and intercompany charge. A separate identification and valuation of the various products and services will not only facilitate the audit of international transactions but will also, where an income tax treaty or convention is in force, assist the treaty partners in their negotiations to avoid double taxation.

11. If the above approach is not practical or proves unrealistic in terms of the manner in which the particular industry conducts its business, then the taxpayer should be prepared to provide, in a comprehensive statement of intercompany pricing policy, the basis on which transfer prices are established world-wide. Such a statement should be based on a thorough functional analysis of the activities and contributions of each group member, and should clarify and quantify the various factors which were considered in establishing the transfer prices, e.g. technical assistance, access to technology, reward for economic risk, financing assistance, etc.

12. 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 the 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 the situation of each taxpayer must be examined on its own particular circumstances and merits.

TRANSFER OF GOODS

13. This section of the circular deals with intercompany purchases and sales of goods including raw materials, semi-finished products and components and finished goods. The same principles apply to the acquisition or disposition of intangible property, as for example the outright transfer of ownership of a patent.

14. The primary method in the view of the Deparment, other tax administrations and the OECD, is to base a tranfer price on a "comparable, uncontrolled price", i.e., a price established in the same market and circumstances by parties who are dealing at arm's length. If there are obvious "comparables" available, as for example where the supplier sells identical goods to both related and unrelated customers, then ordinarily this method would provide the most persuasive evidence of arm's length prices. Application of the comparable, uncontrolled price 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. The Department believes that if the comparable uncontrolled price method is to be used, variations in the respective circumstances should be minor or capable of quantification on some reasonable basis. In cases where there are major differences in prices among the available comparables, the reasons for such differences should be determined; it is possible that certain of the transactions are not truly comparable or not truly uncontrolled. The use of a comparable, uncontrolled price precludes the allocation of related

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product development costs, overhead or royalties unless such charges are also made to unrelated parties which have paid the same price.

Comparable, uncontrolled price method example:

Canco sells product X directly to its United States subsidiary. Canco and others sell product X in the United States to unrelated parties through commission sales agents. By custom, this product is sold FOB the purchaser's plant. An average daily United States transaction price based on sales by commission agents is available from these agents.

The transfer price per ton for a particular shipment is calculated as follows:

Average transaction price for the day	$ 467
DEDUCT:	
Adjustment for saving the 3% agent's commission	14
Freight adjustment (amount reflected in average daily transaction price less actual cost)	31
Total deductions	45
Transfer price	$ 422

15. Where appropriate comparables are not available and the taxpayer must use one of the other methods discussed in the following paragraphs, it is recommended that a thorough functional analysis of the activities of the group members be carried out (as mentioned in 11 above). A functional analysis will identify and evaluate, with respect to a given product or product line, the role and contribution of each member, including the economic risk assumed and the degree of responsibility for engineering and production, continuing research, management and administration, marketing and customer services. A functional analysis will facilitate informed decisions as to what constitutes an "appropriate" mark-up or a "reasonable" profit contribution, and it will help to identify severe distortions in the margins of related parties.

16. Secondary methods of determining a reasonable arm's length price are the "cost-plus" and "resale price" methods. Cost-plus calculations start with the transferor's cost of the goods and add thereto an appropriate mark-up. Resale price calculations work backwards from the transferee's eventual resale price, subtracting therefrom an appropriate margin or gross profit. See 15 above and 17 below for comments on the word "appropriate" in this context.

17. When using the "cost-plus" method, *cost* must be computed in accordance with generally accepted accounting principles or normal commercial accounting practices in the industry in Canada, even though some other computation of *cost* may be acceptable in the foreign country. In determining the cost of a product, the Department does not recognize depreciation based on the replacement or current market value of capital property used in the manufacturing process. When considering the reasonableness of a mark-up, the method used to determine the cost of the product will be considered. If the 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 plus a reasonable profit contribution, whereas if a full absorption costing method is used, a lower mark-up would be indicated.

Cost plus method example:

Canco produces a high-value liquid product in bulk for itself and three foreign subsidiaries of its Australian parent. Canco also does custom formulations for unrelated parties using active ingredients supplied by them. Canco realizes its standard cost plus 22% on these custom formulations.

The transfer price per litre for a particular shipment to a related foreign company is calculated as follows:

Canco standard cost (excluding active ingredient costs)	$ .35
ADD:	
22% of $ .35	.07
Cost of active ingredients	.98
Transfer price	$ 1.40

18. The resale price method is most appropriate in those cases where no comparables are available and the purchaser adds relatively little value to the product. The greater the value of the functions performed by the purchaser, the more difficult the determination of an appropriate resale margin for purposes of the resale price method.

Resale price method example:

Canco is the Canadian distributor for its United States parent's established line of home computers. The parent sells these computers in its home market to six independent distributors at retail price less a discount based on volume purchased during the year.

The transfer price to Canco for a particular computer is calculated as follows:

Resale price (in Canada)	$ 2,600
DEDUCT:	
Discount to Canco (at the percentage allowed to a United States distributor with same purchase volume)	900
Allowance for expenses borne by Canco not borne by the United States distributors (Canco's parent bears these costs for that country)	
– advertising	70
– warranty work	30
Total deductions	1,000
Transfer price	$ 1,600

19. Other methods may be employed in support of one of the three aforementioned methods or in circumstances where none of these methods is appropriate. This is consistent with the recommendations of the OECD. The method utilized should reflect an attempt to present the particular transaction in terms of what would have transpired in an arm's length relationship.

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20. One example of an "other method" would measure a proposed transfer price against a number of "check-points". A particular component might have four of these check-points:
- cost of direct materials of the component,
- full cost of production of the component,
- value of the component as a replacement part, and
- value as a fraction of the market value of the entire product.

In this example the transfer price might be required to satisfy, within reasonable limits, criteria based on the four check-points.

21. It has been suggested that the Department should accept the "value for duty", established for imported goods in accordance with the Customs Act, as representing a reasonable arm's length price for purposes of the Income Tax Act. This is not always possible for a number of reasons, including the obviously different contexts in which valuation of goods is required by the respective Acts.

22. The methods for determining value for duty under the current provisions of the Customs Act resemble those outlined in this circular. Value for duty may now be closer to transfer prices acceptable for income tax purposes; however, differences do remain and the Department is under no obligation to accept the established or reported value for duty when considering the income tax implications of a non-arm's length importation.

INTRA-GROUP SERVICES

23. The intra-group services that present problems are not usually those performed in the ordinary course of business for which there are arm's length comparisons available. The services that most frequently require attention are those which pertain to the special interdependence of the members of a multinational group, and these services can be dealt with in three categories, i.e.:
(i) management or administration services,
(ii) research and development, and
(iii) the use of intangibles.

MANAGEMENT OR ADMINISTRATION SERVICES

24. The Department's interpretation of the law as it applies to "Management or Administration Fees Paid to Non-Residents" is contained in IT-468 and reference should be made to that bulletin. The following remarks on management services are more general in nature and are intended to advise taxpayers regarding acceptable methods or measuring and charging for management services.

25. The transfer of management or administration services is occasioned by a centralization of administration and other common services, usually in the parent company itself but occasionally in a separate entity established for that purpose. Central management or administration expenses should first be categorized as follows:

(a) 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 to its subsidiaries (these expenses should be borne by the parent and applied against its income from investments);
(b) expenses such as the costs of training workers for a new plant that are clearly incurred for the benefit of a single company in the group and are associated with the provision of specific identifiable service to that company; and
(c) expenses that are incurred for the benefit of a number of companies or the group as a whole and are for shared services and facilities, such as a centralized world-wide insurance department, that are usually centralized for convenience or economy.

26. An allocation of central management expenses to a Canadian taxpayer is acceptable only if the taxpayer is in a position to derive a real benefit from the related services. Where a resident taxpayer is staffed by a management team normally associated with a self-sufficient business, the allocation should be limited to expenses than can clearly be identified with the taxpayer and which do not represent a duplication of services already provided by Canadian personnel.

27. The only category of central management or administration expenses that presents an allocation problem is that described in 25(c) above. The basis for allocating these expenses may be more or less complex depending on the structure of the group and the extent to which various costs are common to the group as a whole or pertain to certain members only. In any event, for purposes of such an allocation to a Canadian taxpayer, the basis of allocation should be based on a comprehensive review of the central expenses carried out in advance of the allocation. The basis used must be available for examination by the Department before the allocation will be accepted. The basis of allocation should result in costs being shared in proportion to the benefits received, for example, the allocation of costs of a centralized department based on an estimate of time spent on duties performed for each entity.

28. In a large multinational enterprise having numerous subsidiaries and/or branches in several jurisdictions, the basis of allocation may not always be reviewed each year by the taxpayer, but in such a situation the taxpayer is expected to provide an analysis of any relevant changes from the year under audit back to the taxpayer's most recent comprehensive review, which should not be older than two or three years.

29. As decribed in IT-468, there are income tax implications related to an allocation of management expenses to a Canadian taxpayer under both Part I and Part XIII of the Act.

30. The deductibility under Part I of the "management or administration fee or charge" will be evaluated by reference to the nature and the quantum of the benefits derived. The amount charged by the non-resident should not exceed the expenses that may be allocated

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to the Canadian taxpayer as set out in 25(b) and (c) above, i.e., the expenses incurred solely for the benefit of the Canadian taxpayer and a reasonable share of expenses that are incurred for the benefit of a number of companies or the group as a whole. As mentioned in 26 above, no portion of the amount charged should be in respect of services already provided by Canadian personnel.

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 providing such services has been made and the total charge has been allowed as a deduction under Part. I.

31. Under the provisions of Part XIII, a payment to a non-resident in respect of a "management or administration fee or charge" is subject to a 25% withholding tax. It has historically been important, particularly for the numerous payments to U.S. parent companies, to identify "management fees" (as opposed to expense reimbursements or other charges) and ensure that this tax has been withheld and remitted.

32. Most modern income tax treaties and conventions do not require that management fees be treated as anything other than a component of industrial, commercial or business profits. Such profits are furthermore taxable only in the home jurisdiction of the enterprise earning the profits (except in the particular situation where profits can reasonably be attributed to a permanent establishment of that enterprise in the other jurisdiction). The 25% tax on management fees is therefore not normally exigible where such treaties are in force.

33. Whereas the previous (1941) convention between Canada and the U.S. did not interfere with the Part XIII tax on management fees (except to reduce the tax rate to 15%), the new (1980) convention is a "modern" treaty as described in 32 above. As a consequence of applying the terms of the 1980 convention to payments after 1984, the previous importance of the management fee issue has been greatly reduced.

RESEARCH AND DEVELOPMENT

34. The following comments pertain to the intercompany transfer of research and development (R&D) in the situation where the R&D is performed centrally or in specified companies and made available for the benefit or potential benefit of the group. If, on the other hand, a company engaged in R&D retains the benefits therefrom for its own account and makes this knowledge available to other members by way of licensing agreements, the transfer comprises the "use of intangibles" which is discussed in 40 to 48 below. Of course, a company may handle one division of its research by cost-sharing and another by licensing agreements.

35. In determining the deductibility under Part I of payments for R&D expenses, the Department will look to the nature and quantum of the benefits received, and will ensure that there is no double-charge involved (as for example when R&D is also a component in establishing transfer prices). The Canadian taxpayer obviously must be in a position to benefit from the R&D, if not immediately at least potentially, by having a genuine and substantial interest in the results which the research might produce.

36. Where R&D is performed centrally or in specified companies for the benefit or potential benefit of the entire group, there are essentially two issues to be addressed:

(i) the reasonableness of the basis for allocating these expenses to the various members of the group; and
(ii) the entitlement to any mark-up or profit on the activities of the member conducting the R&D function.

37. It is not possible to specify any basis of allocating expenses as being preferable; the method utilized should be appropriate to the particular circumstances in each case. One possible approach would be to categorize the R&D by line of business and product group, then to allocate the current expenses among those companies who currently deal in the particular product group.

38. Although the Department considers that R&D is more appropriately treated as a cost centre, the entitlement to a mark-up or profit on the activities of the member conducting the R&D function will be considered in relation to the arrangement amongst the corporate group at the time the R&D activity is undertaken. If this arrangement is in the nature of a cost-sharing arrangement where resources are pooled for convenience or economy, each participant would bear its fair share of the net costs in return for a fair share of the usable results of the R&D. There would be no mark-up or profit on the R&D activities in this type of situation. By contrast, if it is other than a cost-sharing arrangement, and the R&D facility is treated as a profit centre, the amount charged to the Canadian taxpayer would be based on a reasonable arm's length price, which normally should not exceed its fair share of those R&D expenses that are (at least potentially) of benefit to Canadian operations, marked up at a reasonable rate.

39. As regards the application of Part XIII, payments for the use of R&D usually attract withholding tax. The main exception is the allocation based on a "bona fide cost-sharing arrangement", which is fully discussed in IT-303 and IT-303 Special Release. It should be noted that such a cost-sharing arrangement precludes a profit element for the R&D function and if a profit element is present, the total amount of the payments under the arrangement will attract Part XIII tax.

USE OF INTANGIBLES

40. When R&D is conducted in a particular company and that company retains control of the resultant body of knowledge, other members of the group usually

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gain access to the knowledge through a licensing agreement or equivalent. Scientific and industrial information and expertise, sometimes referred to as "know-how", may be disseminated in a similar fashion. Intercompany payments under such arrangements usually take the form of royalties or similar payments, and such payments usually attract Part XIII withholding tax. Refer to IT—303 and IT-303 Special Release for the Deparment's views on the application of Part XIII to payments for the use of intangibles.

41. The "intangibles" that are dealt with hereunder include patents, inventions, formulae, processes, designs, patterns and similar types of intellectual property, trademarks, trade names, brand names, franchises, licences, special commercial or industrial information and expertise, copyrights and exclusivity rights.

42. Deductibility under Part I of payments for the use of intangibles is essentially a matter of two issues:
(i) is the payment in fact for the use of the intangible for the year – as opposed to a payment for its outright acquisition or other capital outlay; and
(ii) does the amount of the payment represent a reasonable arm's length price for the value received?

43. Normally a payment for the acquisition of an intangible constitutes a capital outlay and is non-deductible on that basis, subject to possible amortization available under the Act. The more difficult question is the determination of the price for use of an intangible. The following comments will address this question in terms of a royalty rate, since that is the most common form of payment.

44. Ideally, the intra-group royalty rate should be determinable by reference to an arm's length comparable royalty. If a company has issued a licence to an independent manufacturer, in respect of a particular patent, one would expect that the royalty rate so established would represent a reasonable arm's length price for use in intra-group licences covering the same patent.

45. Many multinational groups market their products entirely through branches and subsidiaries, with the result that no arm's length comparable royalty exists. The best that can be expected is to draw comparisons with royalty rates in the same industry or a similar industry involving relatively similar products, similar market conditions, and similar licensing arrangements.

46. The following items might be expected to have a bearing on the determination of a royalty rate:
(a) prevailing rates in the industry;
(b) terms of the licence, including geographic limitations and exclusivity rights;
(c) singularity of the invention and the period for which it is likely to remain unique;
(d) technical assistance, trade-marks and "know-how" provided along with access to the patent;
(e) profits anticipated by the licensee; and
(f) benefits to the licensor arising from sharing information on the experience of the licensee.

47. In the same way that a taxpayer is expected to explain the basis for the intercompany pricing policy when questioned by the Department, the taxpayer should also be prepared to demonstrate the reasonableness of intercompany royalties, having regard to all the pertinent facts and circumstances.

CONFIDENTIALITY OF THIRD PARTY INFORMATION

48. In the context of an income tax audit where the Department has obtained information on comparable prices from third parties that forms the basis of an assessment, the Department will seek written permission from the third parties to disclose the information to the taxpayer involved. If permission is not granted, disclosure of the information is prohibited by subsection 241(1) until legal proceedings have commenced with respect to the assessment issued or, in other words, until the taxpayer has filed a Notice of Claim with the Tax Court of Canada or a Statement of Claim with the Federal Court of Canada. At this point subsection 241(3) applies to permit the Department to release the details on the comparables to the taxpayer assessed.

PART XIII WITHHOLDING TAX

49. Where, as a result of the audit of international transactions, it has been determined that Part I adjustments are required to the Canadian taxpayer, a further consideration is required to determine whether Part XIII tax is exigible on the appropriation and whether or not any relief will be provided if the monies are returned to the Canadian taxpayer.

TAX TREATIES AND COMPETENT AUTHORITY PROCEDURES

50. Canada has entered into a number of bilateral international tax agreements with other countries for the purpose of avoiding double taxation.

51. Many of these International Tax Agreements contain provisions concerning income allocation in accordance with arm's length principles. Generally, these provisions are found in Article 9 of the relevant treaty and are often modelled after Article 9 of the OECD Model Convention concerning the taxation of associated enterprises. These provisions attempt to provide a framework in which an adjustment to profits in one country may be offset by a corresponding adjustment in the other country.

52. Where the treaty provisions concerning the taxation of associated enterprises are not sufficient to resolve a dispute between interested parties, a taxpayer may request competent authority consideration as provided under the Mutual Agreement article of most of Canada's international tax agreements. Refer to Information Circular 71-17R2 for a more detailed discussion of the procedures and acceptability of requests for competent authority consideration.

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PART III – AUDIT POLICY

53. In auditing transfer pricing and related international transactions, the Department's objective is to ensure that Canadian taxpayers have reported their appropriate share of income by paying no more than, or receiving no less than, reasonable arm's length prices in their international non-arm's length transactions.

54. If in a particular case the Department decides to review a taxpayer's intercompany transactions, experienced auditors will examine each component in the package, i.e., transfer prices, royalties, intercompany financing, service fees, etc. This will prevent, for example, the double deduction for a foreign parent's research and development costs – once by way of an intercompany royalty or cost-sharing arrangement, and again as an element of the transfer pricing.

55. The Department will take into account any foreign exchange gain or loss, where applicable, when calculating a transfer price adjustment.

56. In carrying out an international audit, the Department will, to the extent practicable, analyze intercompany transactions by applying the arm's length principle on a transaction-by-transaction basis. This approach is necessary because the Income Tax Act applies to each transaction between the various related parties and not to the Canadian taxable income, return on sales, return on equity or any other measurement of general profitability.

Conference Diary

JUNE 1987

Forum Institut für Management GmbH: Die Steuerreform 1987. Bonn, 4 June (German).

Verlag Neue Wirtschafts-Briefe: Internationales Steuerrecht – Aktuelle Rechtsprechung und Praxis. Essen, 5 June (German).

Prentice Hall Law & Business: The "New" Subchapter S Corporation after the Tax Reform Act of 1986. Los Angeles, 5 June (English).

Legal Studies & Services Limited: Trusts for Europe. Amsterdam , 11-12 June (English).

Legal Studies & Services Limited: The Legitimate and Advantageous Uses for International Operations. Amsterdam, 15-16 June (English).

The American Tax Institute: U.S. Taxation: Partnerships, Trusts & Estates; Incorporating the U.S. Tax Reform Act of 1986. Lésigny, 15-20 June (English).

European Study Conferences Limited: Golden Handshakes, Handcuffs and Hellos – The Taxation Implications. London, 16 June (English).

Prentice Hall Law & Business: Fourth Annual: Structuring Partnership Agreements. New York City, 22-23 June (English).

International Bar Association: Management Buyouts – A Seminar for the Practitioner. Düsseldorf, 25-26 June (English).

National Center for Tax Education and Research: 1987 International Conference on Insurance Taxation. Amsterdam, 29 June-1 July (English).

JULY 1987

European Study Conferences Limited: Tax and Company Aspects of Corporate Reorganisation. London, 2 July (English).

European Study Conferences Limited: Tax & Legal Aspects of Directors' Rewards. London, 7 July (English).

Prentice Hall Law & Business: Fourth Annual: Structuring Partnership Agreements. Vail, Colorado, 23-24 July (English).

SEPTEMBER 1987

International Fiscal Association: The Fiscal Residence of Companies; Tax Problems of the Liquidation of Companies; Taxes and Human Rights (Seminar). Brussels, 6-11 September (English, French, German, Spanish).

International Bar Association, Section on business law: National Tax Developments, Taxes and High Tech Operations, Taxes and International Venture Operations, the Issue of International Securities. London, 14-18 September (English).

International Tax Planning Association: Change or Residence: Individuals; Monte Carlo Workshop. Monte Carlo, 17-18 September (English).

Prentice Hall Law & Business: Fourth Annual: Structuring Partnership Agreements. Los Angeles, 17-18 September (English).

Bureau of European Taxation and Trade: Symposium on the Taxation of Directorship in Europe. London, 28 September 1987.

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Legal Studies and Services Limited, IBC House, Canada Road, Byfleet, Surrey KT14 7JL, United Kingdom.

National Center for Tax Education and Research, Prof. Bernard B. Goodman, Executive Director, 30 Tower Lane, P.O. Box 845, Avon, Connecticut 06001 U.S.A.

Prentice Hall Law & Business, 855 Valley Road, Clifton, NJ 07013, U.S.A.

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U.S.A.:

Taxation of Foreign Currency Transactions under the Tax Reform Act of 1986

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Mr. White is a Certified Public Accountant and an attorney, a member of the California Society of CPAs, the AICPA and the United States Branch of the International Fiscal Association. He received a B.A. from the University of Colorado (1961) and an LL.B. at the University of Missouri School of Law (1964).

One of the somewhat overworked international tax topics and "sujets brûlants" that inevitably surfaced in tax circles during the past several years was the United States (and other country) taxation of foreign currency exchange rate gains and losses. It was virtually impossible to attend an international tax seminar in the United States without being confronted with an extensive outline and "tour de force" presentation chronicling the historical development of the current state of confusion and the absence of certainty in the United States tax treatment of exchange gains and losses. Like Mother Nature, the United States Treasury Department abhors a vacuum, and it reacted, albeit a little on the slow side.[1]

Congress, taking its cue from Treasury, inserted foreign currency transaction provisions into the Tax Reform Act of 1986 (the "Act").[2] The provisions attempt to address and resolve many of the conceptually difficult and complex tax issues relating to the United States taxation of exchange gains and losses. The Act deals not only with occasional commercial and financial transactions, such as borrowing and repaying foreign currency and hedging foreign currency risks, but also with translating financial statements from one currency into another. Interestingly, the Act covers many, but not all transactions denominated in a foreign currency. Transactions not specifically covered under the Act are to be treated under the law in effect prior to the Act.[3] Accordingly, with respect to certain foreign currency transactions, some degree of uncertainty will remain, as the law prior to the Act was based on an inconclusive and inconsistent body of court decisions, Internal Revenue Service rulings and Treasury regulations.[4]

The income tax and financial statement accounting treatment of exchange gains and losses was not a major issue in the United States until the early 1970s when the value of major currencies began to float vis-à-vis the United States dollar.[5] Prior to that time, under the Bretton Woods Agreement, currencies of the major industrialized countries were pegged at a fixed rate to the United States dollar which was, in turn, pegged to gold.[6] Although currencies were occasionally devalued or revalued against the U.S. dollar, the instances when the peg moved up or down the peg board were infrequent and sporadic.[7]

In 1972 currencies of some of the major industrialized countries were taken out of the peg system, and they began to "float".[8] At this time there was no comprehensive or uniform set of rules to govern the taxation of, or accounting for, exchange gains or losses arising from either foreign currency denominated transactions or the translation of foreign currency financial statements. In response to this change in economic environment, the Financial Accounting Standards Board ("the Board") issued FASB No. 8 in October 1975. FASB No. 8 provided guidelines for translating financial statements from one currency into another and adopted the "temporal method" which resulted in unrealized exchange gains and losses attributable to balance sheet assets and liabilities being included in the income statement.[9]

1. The Treasury Department's *Discussion Draft on Taxing Foreign Exchange Gains and Losses* (Announcement 81-4), was released in December 1980 six years after the landmark foreign currency hedging case *International Flavors and Fragrances Inc.*, 62 T.C., 232 (1974), *rev'd and rem'd*, 524 F. 2d 357 (2nd Cir. 1975), *on remand*, 36 T.C.M. 266 (1977), Government appeal dismissed (2nd Cir. 1/6/78) was initially decided by the Tax Court. The Discussion Draft lay fallow for 5 years until it was resurrected May 1985, in another form, *The President's Tax Proposals to the Congress for Fairness Growth and Simplicity*.
2. The foreign currency provisions are contained in new Subchapter J, Foreign Currency Transactions, Sections 985 through 989, IRC. They apply to transactions in tax years beginning after 31 December 1986.
3. Conference Report, No. 313, 99th Cong., 2nd Sess., at page II-669 (1986).
4. For example, compare *National Standard Co. v. Comm.*, 749 F.2d 369 (6th Cir. 1984) (foreign currency denominated obligations repaid and ordinary loss treatment allowed since no sale or exchange) with IRS Private Letter Rulings 8435006 and 8442005 (use of foreign currency to repay foreign currency denominated debt results in loss from sale or exchange of a capital asset and not ordinary loss).
5. On 15 August 1971 President Nixon suspended gold sales and purchases. In December 1971, The Smithsonian Agreement realigned the currencies of the major industrialized countries. The dollar price of gold was increased from $ 35

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U.S. multinationals reacted to floating currencies by entering into currency forward contracts to hedge their exchange rate risks, including the income statement impact of fluctuations in the dollar value of investments in foreign subsidiaries.[10]

With the absence of definitive income tax guidelines, hedging gains and losses arising from forward contracts were treated for income tax purposes by taxpayers inconsistently, depending on which theory produced the least income tax. Net hedging gains were often treated as capital gain income and foreign source, while net hedging losses were often treated as ordinary losses and domestic source.[11]

The business community and, in particular, chief financial officers were generally uncomfortable with the fact that published earnings were subject to the vagaries of currency exchange rates. Management has always had an aversion to surprises, particularly if they arise from events that are difficult to control, much less explain. Even more troublesome was the fact that investors tended to focus on the dollar earnings per share trend line and discount comments about foreign currency gains and losses. The Board was ultimately pressured by the business community to adopt a translation method that would not annually impact the income statement. In 1981 FASB No. 52 was issued, adopting the "functional currency" concept. Under FASB No. 52, translation adjustments attributable to translating foreign currency denominated assets and liabilities of a self-contained foreign operation into U.S. dollars are charged directly to the net worth or equity section of the balance sheet. If the foreign operation was not self-contained, but was an extension of the parent's domestic operations, its functional currency was treated as the U.S. dollar and exchange gains and losses were included in net income.[12] Following in the footsteps of the Board, Treasury issued a Treasury Department Discussion Draft which also proposed the adoption of the functional currency concept.[13]

The stage was set for the adoption of a comprehensive set of foreign currency rules, but nothing happened. None of the tax acts from 1981 through 1985 contained provisions addressing the fundamental issues. A series of court decisions and IRS rulings served to stir the pot, further clouding the picture.[14]

In response to the increasing demand for guidance from both taxpayers and Treasury, Congress incorporated Subpart J, Taxation of Foreign Currency Gains and Losses into the Act.[15] Subpart J adopts the functional currency concept proposed by both the Treasury Department Discussion Draft and FASB No. 52, and a modified version of the judicially developed separate transaction doctrine.[16] Under Subpart J financial statements of both foreign subsidiaries and branches whose functional currency is not the U.S. dollar are to be translated into the taxpayer's functional currency using the profit and loss method.[17] The use of this method has the effect of deferring the recognition of unrealized exchange gains and losses attributable to assets and liabilities reflected on the balance sheet of the branch or subsidiary until they are actually realized.[18] Taxpayers (including foreign subsidiaries and branches) whose functional currency is the U.S.

to $ 38 per ounce. In the summer of 1972, Great Britain allowed the pound to float. This was followed by the floating of the German mark in early 1973. The Jamaica Agreement of 1974, in effect, provided that the gold standard was abandoned and major currencies were to float. See Robert Z. Aliber, *The International Money Game.* Pages 32 to 50 (4th ed. 1983).

6. For more than 100 years, the historic peg for the U.S. dollar was $ 20.67 per fine ounce of gold. The $ 35 parity was adopted in 1934. After 1945 most foreign countries pegged their currencies to the U.S. dollar. See Aliber, note 5 supra, at page 18.

7. The French franc through 1970 was devalued every ten years – in 1919, 1939, 1949, 1959 and 1969. See Aliber, note 5 supra at page 5.

8. Note 5, supra.

9. Under the temporal method, balance sheet assets and liabilities were translated using different exchange rates. For example, cash, receivables, and payables were translated at the balance sheet (current) exchange rate. Revenue and expenses were translated using an average exchange rate for the period, except for items attributable to balance sheet account such as depreciation which were translated at historical rates. *Statement of Financial Accounting Standards No. 8, Accounting for the Translation of Foreign Currency Transactions and Foreign Currency Financial Statements* (1975).

10. Hedging gains or losses pertaining to forward contracts intended to be a hedge of exposed net asset or liability positions were included in net income under FASB No. 8.

11. Various theories emerged in support of both treatments. See e.g. *American Home Products Corp. v. U.S.*, 601 F. 2d 240 (Ct. Cl. 1979) (gain on two forward contracts assigned after being held six months, treated as long-term capital gain). IRS Private Letter Ruling 7847004 (hedging gains or losses are capital or ordinary depending on the character of the risk).

12. Under *Statement of Financial Accounting Standards No. 52, Foreign Currency Translation* all elements of the financial statement are translated using the current exchange rate, the balance sheet date rate for assets and liabilities and the weighted average rate for the period for revenues and expenses. If an entity's functional currency is a currency other than the reporting currency translation adjustments arising from the process of translating the entity's financial statements into the reporting currency are not included in income and are reported separately and accumulated in a separate component of equity, *FASB No. 52, Foreign Currency Translation,* December 1981.

13. The Discussion Draft proposed, inter alia, the use of the profit and loss method for translating the financial statements of foreign branches and subsidiaries whose functional currency is other than the U.S. dollar. See note 1, supra.

14. The Economic Recovery Tax Act of 1981 (ERTA) added section 1256 requiring regulated futures contracts to be marked-to-market, section 1092 requiring the deferral or losses to the extent of unrealized gains on offsetting positions in a straddle, and section 1234A treating terminations of contract right as sales or exchanges. The Technical Corrections Act of 1982 and Tax Reform Act of 1984 also provided amendments to these provisions.

15. See note 2 Supra.

16. Under the "separate transaction" doctrine, the underlying transaction gain or loss is separated from the exchange gain or loss, and the character and source of the amounts are determined separately for tax purposes. *Williard Helburn, Inc. v. Comm.*, 20 T.C. 740 (1953), 214 F2d 815 (1st Cir. 1954). It should be noted that the "integration theory" is difficult to apply when the exchange gain or loss arises in a different tax year than the underlying transaction gain or loss.

17. Section 986 and Section 987, IRC.

18. Prior to the Act, a foreign branch that maintained separate books in a foreign currency could use the separate transaction method, the "profit and loss method", or the "net worth method". The latter method resulted in fluctuations on the dollar value of current assets and liabilities being included in taxable income. Under the " profit and loss method" adopted by the Act and FASB No. 52, foreign currency denominated taxable income is translated into U.S. dollars and fluctuations in the dollar value of assets and liabilities are not reported in income. The separate transaction method was rarely used because of the difficulty in accounting for many transactions. Rev. Rul. 75-107, 1975-1 C.B. 32 and Rev. Rul. 75-134, 1975-1 C.B. 33. Earnings and profits of foreign subsidiaries were determined using either the section 964 Subpart F method (which was similar to the FASB No. 8), the partial Subpart F method (balance sheet gains or losses were not included in income) or the profit and loss method. (Regs. Secs. 1.964-1(a)-(e), 1.902-1(g)(2) and 1.902-1(g)(1)).

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dollar are required to quantify the amount of exchange gain or loss realized from certain commercial or financial transactions denominated in another currency on a transaction-by-transaction basis.[19] The quantified amount is then recognized, characterized, and sourced in accordance with the provisions of the Act.[20] Hedging gains and losses are either to be integrated into or treated consistently with the underlying transaction that is hedged.[21]

FUNCTIONAL CURRENCY CONCEPT

The basic premise underlying the Act's exchange gain and loss provisions is that a taxpayer should be required to quantify and recognize for income tax purposes exchange gains and losses only in those circumstances where a transaction is entered into which is denominated in a currency other than the taxpayer's functional currency.[22] The theory is that if a taxpayer's operating medium of exchange is, for example, apples then as long as he deals in apples their value relative to other mediums of exchange is irrelevant. Once the taxpayer starts to transact business in another medium of exchange such as oranges, then the apple value of the orange must be quantified, accounted for and taxed unless the orange operation is self-contained and does not affect the apple operation directly. In a less theoretical context, if a taxpayer's functional currency is the U.S. dollar a completed transaction denominated in Italian lira has the potential to generate an immediate dollar gain or loss. The impact on the taxpayer's dollar gain or loss affects cash flow in dollars and accordingly it should be recognized for tax and accounting purposes as exchange gain or loss. If a taxpayer's functional currency is the German mark and it borrows in British pounds, exchange gain or loss realized from the date the pounds are borrowed to the date repaid should be quantified in marks and recognized. On the other hand, if a taxpayer's functional currency is the mark and it borrows in marks, a fluctuation in the value of the mark resulting in a change in the U.S. dollar value of the debt should not generate exchange gain or loss since there is no mark cash flow impact. In summary, the use of a particular currency by a taxpayer as its functional currency defers the recognition for income tax and accounting purposes of currency gains and losses on transactions denominated or measured in that currency, but not in other currencies.

> Sausalito, Inc., a U.S. corporation, operates a branch in France. The functional currency of the French branch is the French franc (Ffrs.). In 1987 the branch borrows 1,000 Ffrs. when the exchange rate is 10 Ffrs. = $ 1 and also borrows 2,000 German marks (DM) when the exchange rate is 5 Ffrs. = 1 DM and $ 1 = 2 DM. Both obligations are paid in 1989 when the exchange rates are 5 Ffrs. = $ 1, 2.5 Ffrs. = 1 DM and $ 1 = 1 DM. No foreign currency gain or loss would be recognized on the payment of the FF obligation. Had the functional currency of the French branch been the U.S. dollar a $ 50 exchange loss would have been realized and recognized for U.S. income tax purposes. A 5,000 Ffrs. gain would be realized on the payment of the 2,000 DM obligation and recognized for U.S. income tax purposes when the income statement of the French branch is translated into U.S. dollars, the functional (and reporting) currency of Sausalito, Inc.

The Act provides that all income tax determinations are to be made in the taxpayer's functional currency. The U.S. dollar will, as a general rule, be the functional currency of all taxpayers.[23] Accordingly, exchange gains and losses attributable to transactions denominated in another currency will, as a general rule, be recognized when realized and included in taxable income. However, a qualified business unit ("QBU"), such as a foreign branch or subsidiary of a U.S. corporation which uses a currency other than the U.S. dollar in keeping its books and records, generally must treat that currency as its functional currency, if it is the currency of the economic environment in which a significant amount of the QBU's activities are conducted.[24] Exchange gains and losses of a QBU attributable to changes in the dollar value of its own functional currency are deferred and not recognized currently.

A QBU is a self-contained foreign operation including a branch (or division of a branch), subsidiary or partnership which maintains separate books and records. It may be a division of a single trade or business (vertical, functional or geographical) if it is capable of producing income independently, but it need not be a separate trade or busines for other purposes of the Code.[25]

A variety of factors are to be taken into consideration in identifying the functional currency of a QBU, including the currency in which the books and records are maintained, the principal currency in which revenues or expenses are generated, or funds are borrowed or loaned and the principal currency of related business units taking into consideration the extent of integration with the related units. The rules are very similar to the rules adopted in FASB No. 52.[26]

The Senate Report provides the following example to illustrate that foreign entities dealing primarily in U.S. dollars must use the dollar as their functional currency.

> A controlled foreign corporation Swiss base company keeps its books and records and issues financial statements in Swiss francs. It buys primarily in U.S. dollars from its U.S. parent and sells primarily in U.S. dollars with most of its income treated as Section 954 foreign base company sales (Subpart F) income. The U.S. dollar is the functional currency since the company's activities are conducted primarily in U.S. dollars.[27]

19. Section 988(a)(1)(A), IRC.
20. Section 988(a)(1) and Section 988(a)(3), IRC.
21. Section 988(d), IRC.
22. The U.S. dollar is the reporting and functional currency under section 985 for U.S. tax purposes. However, a taxpayer's sole functional currency in fact may be another currency. In the case of a U.S. corporation all of whose activities are in a QBU in Germany, the German mark could be the sole functional currency.
23. Section 985(a)(1), IRC.
24. Section 985(a)(1)(B), IRC.
25. Senate Report No. 841, 99th Cong. 2nd. Sess., footnote 34, at page 457 (1986).
26. Id., footnote 35.
27. See note 25, supra, example (3), at page 458.

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A QBU whose functional currency is not the U.S. dollar may elect to use the U.S. dollar as its functional currency if (1) the unit keeps its books and records in dollars *or* (2) it keeps its books in a foreign currency, but uses a translation method that approximates the separate transaction method.[28] The election must be made the first year a QBU comes into existence, or in the case of a foreign subsidiary, the first year in which a U.S. person acquires a 50% ownership interest.[29]

The determination of a taxpayer's functional currency is the first and most important step that must be taken in applying the new foreign currency rules. In some circumstances it may be a difficult question of fact, in particular when books and records are maintained and transactions are made in more than one currency. Once the functional currency has been identified it will be treated as a method of accounting which may not be changed without the permission of the Internal Revenue Service.[30]

TRANSLATION OF FINANCIAL STATEMENTS

The good news is that there is now some rational relationship between financial statement and income tax reporting. The bad news is that concepts and reality are ofttimes estranged and rarely meet. Following the general thrust of FASB No. 52, the Act adopts the functional currency concept and requires the use of a modified form of the profit and loss method for purposes of translating the financial statements of both foreign branch operations and foreign subsidiary earnings and profits. The most important aspect of the profit and loss method is that fluctuations in the U.S. dollar value of assets and liabilities recorded on the books of a QBU in a non-U.S. functional currency are not included in the income of a foreign branch or the earnings and profits of a foreign subsidiary.[31] The attempt to provide a degree of conformity between the accounting and tax rules and between branch income and foreign subsidiary earnings and profits rules is admirable. Total conformity, however, was not achieved primarily because of differences (e.g. timing), in the way that foreign operations are taxed in the U.S.[32]

Under general U.S. tax principles, a foreign branch of a U.S. corporation is taxed currently in the U.S. The Act provides that the taxable income of a QBU with a foreign functional currency will be translated into U.S. dollars using the "appropriate" exchange rate. In the case of a foreign branch, the "appropriate" rate is defined as being the weighted average rate for the taxable year.[33] (See Illustration I.) Remittances are to be translated at the exchange rate in effect on the date remitted. Any difference between the value of the foreign currency on the date earned and the date remitted will be treated as exchange gain or loss, ordinary income and foreign source, but foreign source only to the extent the underlying branch income is foreign-source income.[34] (See Illustration II.) Foreign income taxes are to be translated using the exchange rate on the date paid. Refunds of income tax must be translated using the exchange rate on the date of original payment.[35] (See Illustration III.)

The foreign-source earnings of a foreign corporation are generally not taxed currently by the U.S. unless a dividend is paid or one of the constructive dividend

28. Section 985(a)(1)(3), IRC. The FASB No. 8 and old Section 964 Subpart F rules both included unrealized balance sheet gains and losses in income and, accordingly, they would not "approximate" dollar-based accounting, which would include only closed or realized transactions.
29. See note 25, supra, at page 459. The exception to the dollar-based books requirement was included to address the concerns of taxpayers operating in hyperinflationary economies. The regulations may require the use of historical rates for all balance sheet items.
30. Section 985(b)(4).
31. Under the old Section 964 Subpart F rules, the foreign branch "net worth" rules and FASB No. 8, the tax basis income of the foreign operation included unrealized exchange gains attributable to changes in the dollar value of assets and liabilities on the balance sheet.
32. Since the income of a branch is taxed currently the exchange rate used is the rate in effect for the year earned. Dividends from foreign subsidiaries are taxed in the year distributed. The distribution date (not the date the income was earned) is used for determining the exchange rate. When branch profits are distributed an exchange gain or loss is recognized at that time to account for the difference in the rate from the date the income was taxed to the date distributed. Section 986(a)(2) and Section 987(3), IRC.
33. Section 989(b)(4), IRC.
34. Section 987(3)(B), IRC. These rules only apply to distributions out of post-1986 accumulated earnings. Post-1986 distributions out of post-1986 accumulated earnings are to be treated as having been made on a pro rata basis.
35. Section 987(4), IRC.

ILLUSTRATION I – STATEMENT OF INCOME

	Statement of income		*Tax Reform Act of 1986*		
	Functional currency	*FASB No. 52*	*Branch*	*Subsidiary Dividend*	*Subsidiary Subpart F*
Gross profit	14,000	A $ 8,400	A $ 8,400	D $ 7,700	A $ 8,400
Operating expenses	(7,000)	A (4,200)	A (4,200)	D (3,850)	A (4,200)
Income before tax	7,000	$ 4,200	$ 4,200	$ 3,850	$ 4,200
Provision for income tax	(2,100)	A (1,260)	A (1,260)	D (1,155)	A (1,260)
Net income	4,900	$ 2,940	$ 2,940	$ 2,695	$ 2,940

Average rate	0.60 (A)
Dividend date rate	0.55 (D)
Foreign tax paid rate	0.70 (F)
(Used for Illustrations I and II)	

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ILLUSTRATION II – TAXABLE INCOME TRANSLATION

	Tax Reform Act of 1986		
	Branch	*Dividend*	*Subpart F*
Book income, before tax provision	$ 4,200	$ 3,850	$ 4,200
Earnings and profits (see Illustration I)	N/A	$ 2,695	$ 2,940
Taxable income from branch or subsidiary (before adjustments)	$ 4,200	$ 275	$ 2,940[1]
Sec. 902 Gross-up of dividend[5] $\frac{500\text{ (FC)}}{4{,}900\text{ (FC)}}$ x (2,100 (FC) x 0.70 = $ 1,470) = $ 150 (F)		150	
Sec. 960 Gross-up of Subpart F income[5] $\frac{4{,}900\text{ (FC)}}{4{,}900\text{ (FC)}}$ x (2,100 (FC) x 0.70 = $ 1,470) = $ 1,470 (F)			$ 1,470
Taxable income (before foreign currency exchange rate gain or (loss)	$ 4,200	$ 425	$ 4,410
Remittance or dividend at rate earned	$ (300)	N/A	$ (300)
Remittance or dividend at rate distributed	275	N/A	275
Exchange rate gain or (loss)	$ (25)	N/A	$ (25)
Taxable income	$ 4,175	$ 425[3]	$ 4,385[3]
Tax at 34%	$ 1,420	$ 144	$ 1,490
Foreign tax credit[2]	(A) (1,420)	(B) (144)	(C) (1,470)
Net U.S. tax	$ —	$ —	$ 20
Excess foreign tax credit	(50)[6]	$ (6)[6]	$ —

Limitation:

(A) $\frac{\$\ 4{,}175}{\$\ 4{,}175}$ x $ 1,420 = $ 1,420

(B) $\frac{\$\ 425}{\$\ 425}$ x $ 144 = $ 144

(C) $\frac{\$\ 4{,}385}{\$\ 4{,}385}$ x $ 1,490 = $ 1,490

1. Assumes 100% Subpart F income.
2. Assumes foreign currency exchanges rate loss is in same FTC limitation basket as underlying income.
3. If 100% of E&P had been distributed taxable income would be $ 4,165 ($2,695 + $ 1,470 = $ 4,165; $ 4,410 – (0.05 x 4,900 FC = $ 245) = $ 4,165).
4. Amount of dividend received in dollars.
5. Foreign tax converted to dollars on date paid.
6. $ 1,470 – 1,420 = $ 50
   $ 150 – 144 = $ 6

ILLUSTRATION III

FOREIGN TAXES PAID OR REFUNDED – TRANSLATION RATE

	Foreign taxes paid	*Foreign RAR adjustments*	*Application of refunds*	*Net tax due (refund)*	*Exchange rate*
Year 1	100 SF	(40) (1)	—	100	3 SF : 1
Year 2	50 SF	(50) (2) (1)	(40)	10	2 SF : 1
Year 3	—	(2)	(50)	(50)	1 SF : 1
	150 SF	(90) SF	(90) SF	60 SF	

Foreign tax paid year 1 (100 SF at 3:1)	$ 33
Foreign tax paid year 2 (50 SF at 2:1)	$ 25
Foreign tax applied 40 SF at 3:1	$ (13)
Foreign tax refunded 50 SF at 2:1	$ (25)
	$ 20

rules, such as Subpart F, applies. If the earnings of a foreign corporation are distributed as a dividend, the earnings and profits from which the dividend is paid are translated under the Act at the spot rate on the date the distribution is included in income.[36] No foreign currency exchange gain or loss arises on dividend distributions since the exchange rate for translating, taxing and distributing earnings is the same. The same rule applies to that portion of the gain on the sale of stock that is treated as a dividend under Section 1248.[37]

Earnings and profits of a foreign subsidiary which are taxed under one of the constructive dividend rules such as the Subpart F, Foreign Personal Holding Company and Passive Foreign Investment Company provisions are translated using the weighted average rate for the taxable year of the foreign corporation.[38] Distributions of earnings and profits which have been previously taxed will result in the recognition of foreign currency exchange gain or loss to the extent of the difference between the value of the foreign currency on the date taxed and the date distributed. Consistent with the general treatment of foreign currency gains or losses, the amount recognized will be ordinary

36. Section 989(b)(1), IRC.
37. Section 989(b)(2), IRC.
38. Section 989(b)(3), IRC.

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ILLUSTRATION IV – DISTRIBUTION OF ACCUMULATED EARNINGS/TRANSLATION

SUBSIDIARY DIVIDEND

Year	Pretax income (FC)	Foreign tax (FC)	Earnings and profits (FC)	Dividend (FC)	Dividend (US$)	Sec. 78 Gross-up	Total taxable income	U.S. tax	Foreign tax credit	Net U.S. tax	Exchange rate Earnings	Exchange rate Tax
1988	1,000	(200)	800	—	$ —	$ 250	$ —	$ —	$ (—)	$ —	1,0 : 1	1,25 : 1
1989	1,000	(200)	800	—	—	350	—	$ —	(—)	—	1,5 : 1	1,75 : 1
1990	1,000	(200)	800	2,400	4,800**	450	5,850	1,989	(1,050)	939	2,0 : 1	2,25 : 1
	3,000	(600)	2,400	2,400	$ 4,800	$ 1,050	$ 5,850	$ 1,989	$ (1,050)	$ 939		
					(1)	(2)	(1)+(2)					

SUBSIDIARY
SUBPART F INCOME

Year	Pretax income (FC)	Foreign tax (FC)	Earnings and profits (FC)	Earnings and profits (US$)	Sec. 959 Distribution (FC)	Sec. 959 Distribution (US$)	Sec. 78 Gross-up	Subpart F income	Foreign exchange gain*	Total taxable income	U.S. tax	Foreign tax credit	Net U.S. tax
1988	1,000	(200)	800	$ 800	—	$ —	$ 250	$ 1,050	$ —	$ 1,050	$ 357	$ (250)	$ 107
1989	1,000	(200)	800	1,200	—	—	350	1,550	—	1,550	527	(350)	177
1990	1,000	(200)	800	1,600	2,400	4,800**	450	2,050	1,200	3,250	1,105	(450)	655
	3,000	(600)	2,400	$ 3,600	2,400	$ 4,800	$ 1,050	$ 4,650	$ 1,200	$ 5,850	$ 1,989	$ (1,050)	$ 939
				(1)			(2)	(1)+(2)	(3)	(1)+(2) +(3)			

BRANCH INCOME

Year	Pretax income (FC)	Foreign tax (FC)	Net after tax income (FC)	Net after tax income (US$)	Remittance (FC)	Remittance (US$)	Taxable branch income	Foreign exchange gain*	Total taxable income	U.S. tax	Foreign tax credit	Net U.S. tax
1988	1,000	(200)	800	$ 800	—	$ —	$ 1,000	$ —	$ 1,000	$ 340	$ (250)	$ 90
1989	1,000	(200)	800	1,200	—	—	1,500	—	1,500	510	(350)	160
1990	1,000	(200)	800	1,600	2,400	4,800**	2,000	1,200	3,200	1,088	(450)	638
	3,000	(600)	2,400	$ 3,600	2,400	$ 4,800	$ 4,500	$ 1,200	$ 5,700	$ 1,938	$ (1,050)	$ 888
							(1)	(2)	(1)+(2)			

* $ 4,800 amount distributed less $ 3,600 Earnings and Profits (or Net After Tax Branch Income) taxed currently equals foreign exchange gain.
** Distribution in 1990 of total undistributed earnings for 1988, 1989 and 1990.

income. The income will be foreign source, but only to the the extent the underlying income is foreign source.[39] Foreign income taxes are to be translated at the exchange rate on the date of payment and refunds on the original payment date.[40] The use of a different exchange rate for the amount of foreign tax to be credited and for earnings and profits provides some potential for distortion. The dividend gross-up and deemed foreign tax credit, for example, may be different than the foreign tax deducted in arriving at earnings and profits.[41] (See Illustration IV.) It should be noted that the translation rules for Subpart F income and foreign branch income are similar. This is consistent with the theoretical underpinning of Subpart F.

FOREIGN CURRENCY TRANSACTIONS

If a taxpayer whose functional currency is the U.S. dollar entered into a transaction denominated in a foreign currency prior to the Act, the tax consequences were unclear. There was a general judicial acceptance that foreign currency was property and in most in-

39. Section 986(c), IRC.
40. Section 986(b)(1), IRC.
41. In calculating earnings and profits for Subpart F income and dividend distribution purposes the exchange rate to be used for foreign income tax is the same as for other items of income and expense. For Section 78 gross-up purposes the amount added back to taxable income is the tax available as a credit under Section 902 or 960 which is translated into dollars at the rate on the day the tax is paid. Therefore, the "pre-tax" amount in dollars after gross-up may be different than the income before tax in dollars and the effective rate of foreign tax in dollars may be higher or lower then the effective tax rate in local currency.

Example

Foreign currency	*E/R*	*U.S. dollars*
Income before tax	100,000 2:1	50,000
Current tax	(30,000) 2:1	(15,000)
Net income (Earnings and profits)	70,000	35,000
Dividend	70,000 2:1	35,000
Tax paid	30,000 3:1	10,000
Grossed-up dividend	100,000	45,000

Effective foreign tax rate:

Dividend in U.S. dollars (10,000-45,000)	22%
Earnings and profits in foreign currency (30,000-100,000)	30%

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stances a capital asset.[42] The so-called "separate transaction" doctrine, often followed by both the Internal Revenue Service and taxpayers when it served them, dictated that the amount, character, source, and timing of any gain or loss attributable to a fluctuation in the dollar value of an asset due to a change in the exchange rate was determined separately and apart from the underlying commercial or financial transaction.[43] However, there were a multitude of theories which had evolved that supported conflicting results from the same set of facts.[44]

Loan cases presented some of the more interesting timing of recognition issues.

> P, a U.S. taxpayer whose functional currency is the U.S. dollar borrows 100,000 DM from a German bank when the exchange rate is 2 DM = $ 1 and lends 100,000 DM to its German subsidiary, S, subsequently receiving a DM-denominated note when the exchange rate is 1.8 DM = $ 1. The note is paid by S two years later when the exchange rate is 1.6 DM = $ 1. P pays off the bank when the exchange rate is 1.5 DM = $ 1. Under the separate transaction doctrine exchange gain or loss is recognized at each step of the transaction, – the loan to S, the payment by S to P and the payment by P to the bank. Assuming that no underlying transaction gain or loss is realized (i.e. the two 100,000 DM obligations were paid in full) P would quantify the amount of the dollar exchange gain or loss, and report it in the years realized, determining if the amount recognized was U.S. or foreign source, capital gain or ordinary income.[45]

The Act attempts to address the unresolved issues of timing, character and source by first identifying certain commercial transactions, referred to as Section 988 transactions, as being subject to a new set of rules. Section 988 transactions specifically include:

1. the acquisition of or becoming an obligor under a debt instrument (including foreign currency denominated debt that may be paid in the functional currency of the debtor);[46]
2. accruing any item of income or expense where the amount is paid after the date of accrual (subject to a de minimis threshold that may be provided in the regulations);[47]
3. forward or futures contracts or options if not subject to the mark-to-market regime;[48]
4. dispositions of nonfunctional currencies by sale or otherwise.[49]

Transactions not specifically identified as Section 988 transactions such as the acquisition of tangible real or personal property or shares of stock are apparently excluded from the provisions of the Act and remain subject to the rules in effect prior to the Act.[50] For example, if a U.S. taxpayer whose functional currency is the dollar acquires 1,000 shares of stock in a Dutch corporation for 2,200 Dutch florins (Dfl.) when the exchange rate is 2.2 Dfl. to $ 1 and sells the shares for 2,200 Dutch florins when the exchange rate is 2.0 Dfl. to $ 1, then the exchange gain would be subject to the pre-Act rules.

The fundamental issues are clearly addressed under the Act. Foreign currency gain or loss will generally be treated as ordinary, rather than capital income, and in some instances interest to the extent provided in regulations.[51] Capital gain or loss treatment, however, may be elected with respect to exchange gain or loss attributable to a forward or futures contract or option which is a capital asset.[52] The source of exchange gains or losses under the Act will be the residence of the taxpayer or the QBU in whose books the transaction is properly reflected. For this purpose, residence for individuals will be their tax home as defined in the Code. Residence for other U.S. persons will be the United States. Residence for the QBU of any taxpayer, including individuals, will be the country in which the QBU has its principal place of business.[53] The Act addresses the timing issue by providing that exchange gain or loss is to be determined by comparing the exchange rate on the "booking date" to the exchange rate on the payment date (in the case of debt and accrual transactions), acquisition date and disposition date (in the case of dispositions of nonfunctional currency), or date of payment and date rights are terminated (in the case of forward and future contracts and options).[54]

Although the Act requires that foreign currency gain or loss be quantified and treated separately from any underlying transaction, the Conference Report indicates that the separate transaction doctrine is modified so that the foreign currency gain or loss is limited to the total gain or loss from the transaction taking into consideration the underlying transaction gain or loss.

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42. *Gillin v. U.S.*, 423 F.2d 309, 25 AFTR 2d 70-864 (Ct. Cl. 1970).
43. See note 17, supra.
44. The Internal Revenue Service unsuccessfully raised both the *Corn Products* (*Corn Products Refining Co. v. Comm.* 350 U.S. 46 (1955)) doctrine and the short-sale (Sec. 1233) theory in *International Flavors and Fragrances, Inc.* See note 1 supra.
45. *See KVP Sutherland Paper Company v. U.S.*, 344 F.2d 377, 15 AFTR 2d 919 (Ct. Cl. 1965).
46. Section 988(c)(1)(B), IRC. See also Senate Report No. 841, 99th Cong., 2nd Sess., page 460 which makes it clear that exchange gain or loss will be recognized if the amount paid or received is determined by reference to the value of a nonfunctional currency even though paid in a functional currency.
47. Ibid. See also Senate Report No. 841, 99th Cong., 2nd Sess., page 460. Trade receivables and payables having a maturity of 120 days or less and any other receivable or payable with a maturity of six months or less that would be eligible for exclusion under Section 1274 are examples of items that are within the scope of the Secretary's regulatory authority.
48. Section 988(c)(B)(iii), IRC. Under the Section 1256, mark-to-market regime regulated futures contracts (futures contracts traded on an exchange, foreign currency contracts traded in the interbank market, listed non-equity options, and listed dealer options) are marked-to-market at year end and treated as 40% short-term and 60% long-term capital gain.
49. Section 988(c)(i)(c), IRC. Nonfunctional currency is broadly defined to include coin, currency and demand or time deposits.
50. See note 25 supra, at page 469.
51. Section 988(a)(2), IRC.
52. Section 988(a)(1)(B), IRC. This election covers only forward contracts, futures contracts and options which are not regulated futures contracts (RFCs) marked-to-market under Section 1256. Only contracts that are traded on a "qualified board of exchange" such as the German mark or British pound, are RFCs. Futures in currencies which are not so traded such as the Australian pound or Italian lira are not subject to the Section 1256 regime and, therefore, qualify for Section 988 treatment.
53. Section 988(a)(3), IRC.
54. Section 988(b), Section 988(c)(2), Section 988(c)(3), Section 988(c)(1)(C)(i)(II), IRC.

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Accordingly, if there is no net gain or loss from the transaction, taken as a whole, then any currency gain or loss realized will not be recognized. The following is an expanded example taken from a description in the Conference Report of the application of the limitation modification.[55]

Limitation on the recognition of foreign currency gains or losses realized

	US$
1. Taxpayer acquired a 1,000 FC obligation when the exchange rate was 1 FC = $ 1 and sells the obligation for 2,000 FC when 1 FC = $ 2.	
(a) U.S. dollar gain or (loss) realized $ 4,000 – $ 1,000	3,000
(b) Transaction gain realized 2,000 – 1,000 = 1,000 FC x $ 2	2,000
(c) Foreign currency gain or (loss) realized (1,000 FC x $ 1 = 1,000)	1,000
(d) Foreign currency gain or (loss) recognized	1,000 *
2. If 1 FC = $ .5 at date of sale:	
(a) U.S. dollar gain or (loss) realized $ 1,000 – $ 1,000 =	0
(b) Transaction gain or (loss) realized 2,000 – 1,000 = 1,000 FC x $ .5	500
(c) Foreign currency gain or (loss) realized (1,000 FC x $ .5 = ($ 500))	(500)
(d) Foreign currency gain or (loss) recognized	0 *
3. If 1 FC = $ .75 at date of sale:	
(a) U.S. dollar gain or (loss) realized $ 1,500 – $ 1,000 =	500
(b) Transaction gain realized 2,000 – 1,000 = 1,000 FC x $ .75	750
(c) Foreign currency gain or (loss) realized (1,000 FC x $ .25 = ($ 250))	(250)
(d) Foreign currency gain or (loss) recognized	0 *
4. If 1 FC = $ .25 at date of sale:	
(a) U.S. dollar gain or (loss) realized $ 500 – $ 1,000 =	(500)
(b) Transaction gain realized 2,000 – 1,000 = 1,000 FC x $ .25	250
(c) Foreign currency gain or (loss) realized (1,000 FC x $ .75 = ($ 750))	(750)
(d) Foreign currency gain or (loss) recognized	(500)*

* U.S. dollar gain or loss is first attributed to foreign currency gain or loss realized from the transaction which is the units of functional currency originally booked by the taxpayer times the difference in the exchange rate from the booking data to the payment date. However, the amount of foreign currency gain or loss recognized may not exceed the amount of the net U.S. dollar gain or loss from the transaction.

HEDGING TRANSACTIONS

Fluctuating currency exchange rates create economic risks which can be partially offset by entering into a transaction commonly referred to as a hedge. Prior to the adoption of FASB No. 52, multinational corporations frequently hedged their net investments in foreign subsidiaries to neutralize the FASB No. 8 income statement impact of balance-sheet translation gains and losses.[56] Even more common was the purchase of currency futures or options to hedge potential changes in the dollar value of current foreign currency obligations or assets.

> Mill Valley, Inc., a U.S. corporation, purchases 100 surfboards from Moulins, S.A., a French company, for 7,000 French francs (Ffrs.), with payment due in 90 days. At the time of the receipt of the invoice 7 Ffrs. equals $ 1 and a $ 1,000 payable is recorded on Mill Valley, Inc.'s books. To hedge against any gain or loss resulting from currency rate fluctuation, Mill Valley, Inc. purchases 7,000 Ffrs. 90 days forward in the forward market for $ 1,030. At the time of payment the Ffrs. has declined to 7.5 Ffrs. to $ 1. Mill Valley, Inc. sells the Ffrs. for $ 933 and realizes a $ 97 loss ($ 1,030 cost – $ 933 sales price). He satisfies the 7,000 Ffrs. obligation by purchasing Ffrs. for $ 933 and realizes a $ 67 gain.

Prior to the Act it was not clear whether the $ 97 exchange loss on the forward contract and the $ 67 exchange gain on the account payable should be segregated and treated separately for income tax purposes, or integrated. By treating them separately, the source, timing and character of the gain and loss could potentially be treated differently.

Under the Act, hedging transactions involving Section 988 transactions, if identified as hedges by either the taxpayer or the Secretary, are to be integrated with the asset or liability hedged and treated as a single transaction.[57] The Senate Report distinguished two types of hedges. Fully hedged "integrated economic package" hedges are to be treated as dollar borrowings with dollar interest payments since the taxpayer has assured itself of a cash flow that will not vary with exchange rates. The Report provided the following example of the application of the integration theory to a fully hedged foreign currency borrowing.[58]

55. See note 3 supra, at page II-664.
56. Many of the exchange gain or loss court cases in recent years arose out of this practice. The issue generally was the character of the gain or loss. See *American Home Products Corp. v. U.S.*, 601 F.2d 240 (1979) (gain on two forward contracts assigned after being held six months treated as long-term capital gain) and *Hoover Co. v. Comm.* 72 T.C. 206 (1979) (acq. 1984-C.B. 1) (losses incurred in 18 forward sale agreements entered into to hedge investments in foreign subsidiaries were capital, either long-term or short-term depending on the holding period of the contract).
57. Section 988(d)(1).
58. See note 25 supra, at page 466. See also Internal Revenue Service's Advance Notice on Certain Fully Hedged Foreign Currency Transactions, Released 31 December 1986.

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Fully hedged "integrated economic package" foreign currency borrowing treated as a U.S. dollar borrowing:

1. Taxpayer in 1988 borrows 1,000 FC at 30% for two years when exchange rate is 2 FC = $ 1 and records a $ 500 liability.
2. Taxpayer purchases FC forward to pay 300 FC interest in 1989 and 300 FC interest plus 1,000 FC principal in 1990.
3. Spot market rate one year forward is 2.364 and two years forward is 2.793 per US$.
4. U.S. dollar obligation in 1988 $ 500
   U.S. dollar cost to repay obligation
   – 300 FC @ 2.364 (127)
   – 1,300 FC @ 2.793 (466)
   (593)

   Net U.S. dollar cost to borrow $ 500 for two years $ (93)

   Effective interest rate in U.S. dollars 10%

5. Amount paid in 1989
   300 @ 2.364 $ 127
   Amount treated as interest ($ 500 x 10%) for 1989 (50)
   Amount treated as principal for 1989 $ 77

The other type of hedge discussed in the Report is the "exposure in a particular currency" hedge. The regulations will not require complete integration for this type of hedge, but will require consistent treatment. Presumably, this would include hedging the dollar value of assets including an investment in a foreign subsidiary.[59]

Since all transactions which are part of a Section 988 hedge are to be integrated or treated consistently with the asset or liability being hedged, the straddle loss deferral rules and mark-to-market regime will not apply.[60] Where a gain or loss is realized on a futures contract that is not a hedge, the gain or loss will be treated under the regular Section 988 rules as ordinary income unless the mark-to-market regime applies.[61] As noted above a taxpayer will have the ability to elect to treat certain speculative Section 988 futures transactions (which are not part of a straddle and not subject to the mark-to-market regime) as capital gain transactions not subject to the general rule for Section 988 hedging transactions.[62]

OTHER CURRENCY TRANSACTIONS

Interestingly, transactions entered into by individuals that are not investment or business related are not covered by Subpart J.[63] If an individual purchases a personal residence in France for 700,000 Ffrs. with 500,000 Ffrs. debt (7 Ffrs. to $ 1) and sells the house for 900,000 Ffrs. (6 Ffrs. to $ 1), paying off the 500,000 Ffrs. debt, the pre-Act rules would apply to the exchange gain realized on the sale of the house and the exchange loss realized on the payment of the debt. Presumably a taxpayer could treat the exchange loss as deductible home mortgage interest and the exchange gain as deferrable under Section 1034 if the house otherwise qualified as his principle residence.[64]

To prevent the artificial creation of foreign-source income necessary to use foreign tax credits, the Act provides that foreign currency denominated loans made by a U.S. person to a 10% owned foreign corporation at an excessive interest rate will be marked-to-market annually and treated as domestic source for foreign tax credit limitation purposes.[65]

Prior to the Act a common technique for avoiding the taxation of exchange gain attributable to debt obligations was to treat the gain as being the equivalent of debt forgiveness and to elect to defer the gain. The Senate Report makes it clear that any gain on the repayment of debt will first be allocated to currency exchange gain and only the excess will be treated as a forgiveness of indebtedness.[66]

CONCLUSION

The exchange gain and loss provisions of the Act represent a good first attempt at clarifying what can only be described as a difficult and very complicated area of the law. However, there is no question that additional guidance will be required in particular with respect to unresolved translation and hedging issues. Until regulations are issued taxpayers will be groping a little, but the Act has served to take them out of the dark. As with other provisions of the Act, there is a broad mandate for the Treasury to prescribe regulations to carry out the purposes of Subpart J.[67]

59. The Senate Report No. 841, 99th Cong., 2nd Sess., at page 465 indicates that a hedge "designed to limit a taxpayer's exposure in a particular currency (e.g. the acquisition of a foreign currency denominated liability to offset exposure with regard to a foreign currency denominated asset)" will not be fully integrated, but will require consistent treatment.
60. Section 988(d)(1), IRC. Sections 1092 and 1256 do not apply to "hedges" as defined in Section 1256(e), but this definition includes only hedges entered into by the taxpayer in the normal course of the trade or a business. Section 988 hedges are not restricted to trade or business hedges.
61. Section 988(a)(1), IRC.
62. Section 988(a)(1)(B), IRC.
63. Section 988(e), IRC.
64. The theory for this treatment is that the exchange gain and loss are treated the same (i.e. interest and gain on sale of personal residence) as the asset and liability to which they relate.
65. Section 988(a)(3)(C), IRC.
66. See note 25 supra, at page 461.
67. Section 988(c), IRC, for example, provides that the Secretary shall prescribe regulations covering the conversion from the net worth method to the profit and loss method limiting exchange losses on remittances from QBUs, recharacterizing interest and principal payments with respect to obligations denominated in certain hyperinflationary currencies, adjustments to Section 905(c), and the appropriate treatment of related party transactions.

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PEOPLE'S REPUBLIC OF CHINA:

The Emergence of Local Investment Regulations

The Government of the People's Republic of China has continued to complete the legislative framework for the enterprise sector, particularly for foreign investment in China.

In addition to the laws, regulations, etc., which are released by the Central Government, there are many rules established and released by local authorities which apply only within their jurisdictions.

To keep track of all the developments on the local level causes problems since there is no official publication reporting on such developments on a regular basis.

The National Council for US–China Trade in Washington D.C. has published, in its journal The China Business Review (January-February 1987, at page 18) a compilation of those local provisions. The following list is based on the compilation as cited whereby developments as they were observed in the meantime are added.

We would like to express our thanks to the National Council for US–China Trade for the permission to use their compilation as the basis for this survey.

PROVINCES:

Anhui:	2 March 1987
Fujian:	17 November 1987
Guangdong:	13 October 1986
Guangxi:	13 January 1987
Guizhou:	24 November 1986
Hebei:	15 November 1986
Hunan:	24 November 1986
Jiangsu:	10 November 1986
Jiangxi:	15 October 1986
Liaoning:	1 December 1986
Shandong:	24 November 1986
Sichuan:	February 1987
Xinjiang:	3 November 1986
Yunnan:	3 January 1987
Zhejiang:	29 October 1986

PROVINCIAL-LEVEL MUNICIPALITIES:

Beijing:	12 October 1986
Shanghai:	5 November 1986
Tianjin, Tianjin EDZ:	12 October 1986

CITIES/EDZs:

Anshan:	7 November 1986
Chongqinq:	10 February 1987
Dalian:	22 September 1986
Fuzhou:	8 December 1986
Guangzhou, Guangzhou EDZ:	10 November 1986
Lianyungang:	24 October 1986
Nantong, Nantong EDZ:	2 March 1987
Ningbo:	16 October 1987
Qingdao:	8 December 1986
Qinhuangdao EDZ:	4 December 1986
Yantai:	16 February 1987

SEZs/REGIONS:

Gannan Autonom. Region (in Gansu Province):	5 November 1986
Shenzhen SEZ:	10 November 1986
Xiamen SEZ:	6 November 1986
Zhuhai SEZ:	6 November 1986

Please note that the dates indicated are the dates when the regulations were mentioned or appeared in the press.

SEZ refers to Special Economic Zone, EDZ refers to Economic (and Technological) Development Zone.

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HIGHLIGHTS OF THE INDIAN 1987-88 BUDGET

DIRECT TAXES

1. No change in personal or corporate income tax rates. Surtax on company profits abolished.
2. Every company will have to pay a minimum tax on 30% of the book profits.
3. Depreciation rules liberalized from April 1987, permitting 3 rates, i.e. of 100%, 50% and 33⅓% for plant and machinery.
4. Deduction permitted under section 80CC for investment in equity shares extended for 3 more years and the holding period of these shares reduced from 5 years to 3 years.
5. Holding period for shares for concessional capital gains tax treatment reduced from 36 to 12 months to improve mobility of capital invested in shares.
6. Companies will pay tax on long-term capital gains from immovable property at 45% and at 35% from other property. Capital gains on the sale of land and buildings in cases where industries shift from urban areas to rural areas is proposed to be exempted on satisfaction of certain conditions.
7. Capital gains on transfer of goodwill of a concern or transfer of assets from firm to partner and vice versa will be chargeable to tax.
8. Additional tax on undistributed profits in the case of closely-held companies is to be omitted from the assessment year 1988-89.
9. Deduction under section 80RRA will now be available to the extent of 50% of remuneration or 75% of remuneration remitted in convertible foreign exchange, whichever is higher.
10. Tax at specified rates would be deducted at source from fees from professional and technical services, royalties, rent, commission or brokerage and payments for goods supplied to the Government above prescribed amounts.
11. Any compensation received by an employee at the time of voluntary retirement from a public sector undertaking will not be chargeable to tax.
12. Deduction under section 80U for blind and handicapped persons is being increased from 10,000 Rs. to 15,000 Rs.
13. New savings scheme under which 50% of deposits up to a maximum of 20,000 Rs. will be eligible for tax exemption.
14. Repayments of loans and payments up to 10,000 Rs. annually towards construction or purchase of new residential property will qualify for deductions under Section 80C of the Income-tax Act.
15. A 15% tax on foreign exchange released for foreign travel excluding educational and medical travel abroad.
16. New comprehensive legislation is proposed to increase taxation of users of 5-star hotels.

INDIRECT TAXES

1. The MODVAT scheme will be extended to all sectors except textiles, tobacco and petroleum. The scheme is also being simplified to eliminate the cascading effect of excise duties.
2. Excise duty on aerated soft drinks and soda increased by 20 paise and 15 paise a bottle, respectively.
3. Excise duty on chewing tobacco, placed at 55%.
4. Pattern of excise duty on cigarettes changed from printed prices on the packet to the length of cigarettes.
5. Increase in duty of 150 Rs. on black-and-white TV tubes and 600 Rs. on colour TV tubes. Excise duty on costlier colour TV sets increased from 1,500 Rs. to 1,750 Rs.
6. Excise duty on fluorescent tubes reduced to 2 Rs. per tube.
7. Excise duty exemption on shoes raised from 45 Rs. to 60 Rs.
8. Excise duty on imported components for motor vehicles not exceeding 1000 cc, increased from 20% to 25%. Components for fuel-efficient automobiles for the handicapped fully exempted.
9. Duty on imported crude oil raised by 500 Rs. a ton which, however, will not be passed on to the consumer.
10. Differential tariff rates for import of general machinery equalized at 85% while duty for components will be 15% below applicable rate.
11. Import duty on machinery and equipment for the food-processing industry cut from 101% to 50%.
12. Excise duty on 36 new drug intermediaries exempted.
13. Leather industry permitted to import 31 new items of machinery at a concessional duty of 35%.
14. Excise duty on feature films reduced by 10%.
15. Import duty on electronic goods raised from 25 to 30%.
16. Excise duty of 10% on computers and peripherals. Duty on computer system imported under OGL reduced from 150% to 140%.
17. Customs duty on 46 items of gems and jewellery reduced to 35%.
18. Excise duty rebate of 50 Rs. per ton for cement produced by new units.
19. Reduction in basic customs duty on low-density polyethelene.
20. Duty on domestic capital goods such as steel foils and steel plates reduced to 85%. Duty on import of textile plant and machinery reduced to 65% from 245%.
21. Excise duty on viscose staple fibres increased from 5 Rs. to 7 Rs. per kilogramme.
22. Excise duty on steel ingots increased from 315 Rs. to 365 Rs. a ton.
23. Import duty on foundries reduced from 101% to 55%.

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INDIA:

Budget 1987/88

By Kailash C. Khanna

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The Union Budget for the fiscal year 1987-88 was presented to Parliament on Saturday, 28 February 1987, by Prime Minister Rajiv Gandhi who is currently holding the finance portfolio. Mr. Gandhi outlined his Government's objectives by quoting at the outset an observation of India's first Prime Minister, the late Jawaharlal Nehru:

> We have to strive with all our strength for our planned development by conserving all our resources, increasing production and trying to ensure progressively a more equitable distribution, and thus to raise the standards of the great mass of our people.

He reiterated these objectives in his Budget Speech stating that the elimination of poverty and the building of a strong, modern, self-reliant independent economy were his principal aims. Mr. Gandhi went on to add that,

> The overall economic situation is good. Our foodstocks and foreign exchange reserves are quite satisfactory. We have been able to keep our overall price situation under control through judicious demand and supply management. Along with expenditure control, we will continue to take anticipatory action to reduce excess liquidity and increase supply of sensitive commodities.

Unfortunately, a close study of facts does not fully warrant the optimism displayed by Mr. Gandhi. The revised budgetary estimates for the previous year 1986-87 show a huge deficit of 82,850 million Rs. against the originally projected figure of 36,500 million Rs., a rise of as much as 127%. The management of non-plan expenditure during the said year left much to be desired. Interest payments increased by 10.3%, export promotion subsidies rose by 42% and defence spending, the single largest factor of non-plan expenditure, registered a rise of 16.8%. In spite of higher collection of direct taxes, the share of income tax was around a mere 4% and corporate tax 5.3% of total receipts, thereby increasing further dependence on indirect taxes.

Mr. Gandhi has candidly admitted in his Budget Speech "The deficit is high and I do not like it. I have decided that the deficit in the Budget Estimates for 1987-88 shall not be exceeded." While wishing him well, several critics have remarked that budgetary deficits cannot be controlled by Canute style command alone. Rapid expansion of industrial and agricultural production, a higher growth rate and strict control over unproductive expenditure are essential for a balanced economy. Admittedly, the Prime Minister has had numerous constraints and difficulties in drawing up the outline of his Budget. But his suggestions lack any growth thrust and in the light of past experience grave doubts have been expressed whether the estimated deficit of 56,880 million Rs. for 1987-88 will be kept within limits. In fact, some disturbing features lead to greater misgivings. The central plan size has been increased by a meagre 4.2% over the revised Budget estimate for 1986-87 and cuts have been imposed on allocations to energy, industry and minerals. On the other hand, the estimated expenditure on defence will rise to a new high of 125,120 million Rs., showing a steep increase of 43.4% over the budgeted figures for the last year and representing about 31% of the total non-plan expenditure. While there is universal agreement with Mr. Gandhi's statement that "no compromise is possible where the country's defence is concerned", apprehension has been expressed that part of the defence expenditure may be wasteful, particularly as it is not subject to close scrutiny. When a Member of Parliament likened the Defence Ministry to a "holy cow", Mr. Gandhi retorted, "But it has yielded adequate milk whenever required". Next to defence expenditure, estimated interest liabilities reveal an increase of over 10% and give cause for anxiety with the total national debt presently standing at a staggering figure of around 1,630,000 million Rs. In case the estimated deficit for 1987-88 is exceeded, as is likely, it is bound to stoke the flames of inflation. However, Mr. Gandhi has given indications of a supplementary budget later in the financial year, if necessary.

It must be said to the Prime Minister's credit that he has endeavoured to maintain the momentum of the Government's anti-poverty programmes, and plan outlays for rural development have been substantially stepped up. Likewise, financial provision for education and housing has been increased. But, as Mr. Gandhi himself mentioned in the Budget Speech, "achievement of physical targets is far more important than just spending the money". Regrettably, experience has shown that, to borrow the words of a prominent analyst, "anti-poverty programmes have a tendency to degenerate into pro-party programmes". These measures cannot alleviate poverty and authoritative reports have revealed that only a fraction of

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the amount spent reaches the target groups. Real remedy lies in greater productivity since poverty cannot be removed at a rate faster than that permitted by productivity. With 15.5% of the total world population, India shares only 1.5% of the total world income and still has about 250 million individuals below the poverty line. The problems facing the country are colossal and demand a high degree of economic and socio-political acumen to resolve them.

After the end of his hundred-minute long Budget Speech, Mr. Gandhi obliged the waiting newsmen outside Parliament House with a one line description of the Budget – "Budget for poor and growth". Upon this, Mr. Nani Palkhivala, the eminent jurist, commented that the conjunction "and" was redundant, the correct interpretation would be "Budget for poor growth". There is no doubt that the Budget has aroused little enthusiasm, has been widely described as routine and without any direction or philosophy. In fact, less than three weeks before the presentation of the Budget, the Prime Minister stated at the inauguration of the 29th Congress of the International Chamber of Commerce in New Delhi that his Government proposed to rationalize the tax system to help the capital markets grow and raise funds for the private and public sectors. Presumably, this statement aroused expectations of a saucy feast of fiscal incentives and concessions in the Budget but the suave and gentle Mr. Gandhi instead served a cold and insipid fare which will neither whet industry's appetite nor lure a diffident investor. Undoubtedly, he has thrown a few crumbs of relief here and there, but these are too trivial to be of any consequence.

Let us now look at some of the major tax proposals contained in the Finance Bill, 1987. Mr. Gandhi's suggestions to continue the existing deduction in respect of investment in equity shares of specified new companies for a further period of 3 years and his intention to reduce the holding period of these shares from 5 to 3 years are welcome.[1] But the benefit of a general reduction in the period of holding of shares in a company from 36 months to 12 months for eligibility for concessional tax treatment of capital gains realized on the transfer of such shares is open to some doubt. The proposal will provide greater flexibility to investors but it is a moot point if it will improve the health of the capital market. A genuine investor values long-term prospects of growth and a regular, adequate return on his investment; a mere dabbler in shares intent on making a fast buck may improve the mobility of capital invested in shares, but the aggregate pool of investible funds is unlikely to show an early rise. The long range results are difficult to predict.

It has also been further suggested that capital gains arising from the transfer of a capital asset, being shares in a company, shall be exempt from tax if the said capital asset is transferred to a notified public sector company. The suggestion is inequitable and may lead to an increase in the holding of public sector companies by placing a premium on transfer of shares to them. Contrary to court rulings, capital gains on transfer of goodwill of a concern or on transfer of assets from a firm to its partner and vice versa are to be brought within the ambit of taxation. In order to promote decongestion of urban areas, exemption from tax on capital gains arising on transfer of long-term capital assets of business, in connection with shifting of an industrial undertaking from an urban to a non-urban area, are proposed to be exempt from tax provided the gains are reinvested in approved relocation schemes within the specified period. This is a salutary suggestion. Widely-held domestic companies will pay capital gains tax at slightly reduced rates of 45% and 35% on gains in excess of 10,000 Rs. from immovable property and other assets respectively. However, in the case of non-resident companies the tax rate will go up from the existing 50% and 40% to 58.5% and 45.5% on capital gains in excess of 10,000 Rs.

The much publicized tax relief for payments made towards purchase or construction of house property is hemmed in by so many limitations that it loses its value. Briefly, it is proposed that the repayment of loans or payments made towards construction or purchase of a residential house shall be allowed as deduction on the same lines as life insurance premiums, provident fund contribution, etc., subject to a maximum of 10,000 Rs. during a previous year. The overall ceiling of 40,000 Rs. provided in section 80C of the Income-tax Act will be applicable. This leaves little scope for substantial tax benefit and, in most cases, only 40% of the payment will qualify for deduction. The qualifying limit should be enhanced to make the concession meaningful. The deduction amount will not include the cost of land unless it forms a composite part of the total consideration, nor will the cost of any additions or alterations to the existing residential premises. The rationale is not clear. If additional independent residential units can be provided by adding a further storey or an annexe or through alterations, why should payment for this purpose be denied concessional tax treatment? An amendment is required. If the house property is transferred within a period of 5 years after taking possession, the aggregate of the deductions allowed shall be chargeable to tax as the income of the year of transfer. This is a severe penalty and exceptions must be made for extenuating circumstances.

It is intended to permit deduction of 50% of deposits made in a new national savings scheme, subject to a maximum deposit of 20,000 Rs. only. Reference to this scheme has been made in detail in the Long Term Fiscal Policy statement which specifically states that

1. *Editor's note:* Where an individual has acquired new equity shares in an Indian public company engaged in the business of construction, manufacture or the production of any articles other than articles specified in the Income-tax Act, or in providing long-term housing finance (if approved by the Central Government) out of his income chargeable to tax, an allowance equal to 50% of the cost of the share will be allowed. Where the cost exceeds 20,000 Rs. the amount with reference to which the allowance will be permitted will be limited to 20,000 Rs. The equity shares must be part of the initial issue of capital and must have been offered for subscription to the public. The investment must be held for at least 5 years. Certain other conditions are also specified.

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the deduction from taxable income will be "without any overall ceiling". Why then the proposed limit of 20,000 Rs.? Apart from detracting from the scheme's utility, it contradicts the officially authorized fiscal policy statement. The upper limit of 20,000 Rs. should be deleted or raised substantially. In case any withdrawals are made, an amount equal to 50% of the deduction allowed shall be deemed to be income in the year in which the withdrawal was made.

The proposal to impose a "minimum corporate tax" on at least 30% of the "book profits" of every company stems from a curious view of the "phenomenon of the so-called zero-tax highly profitable company" referred to in the Budget Speech. Time and again, it has been emphasized that a "zero-tax" company, as such, is a myth. It is a figment of an errant mind. A company which maximizes its productivity and profitability through diligent, lawful and efficient utilization of its resources and tax allowances; which adds to the gross national product by additional production of goods and services; and which generates further employment, earns valuable foreign exchange, pays greater indirect taxes and other levies to the Central and State exchequers does not deserve the stigma of a "zero-tax" company simply because it legally extinguishes its liability to corporate tax which, in any case, forms a small part of the total tax revenue. The imposition of a minimum corporate tax is the very negation of the concept of rapid growth induced by accelerated depreciation and development allowance. The Explanatory Memorandum accompanying the Finance Bill which shows the proposed minimum tax as a "measure against tax avoidance" betrays a lack of understanding of the basic principles of fiscal economies. Tax avoidance, if any, should be tackled within the rule of law and not through a general fiat of penal taxation. Strong representations have been made to Mr. Gandhi to drop this proposal, particularly when a definite assurance to this effect has been given in the Long Term Fiscal Policy statement (see paragraph 5.20 thereof). When the investment allowance has been buried why should the minimum tax concept be resurrected? Frequent deviation from expressly stated Government policy is bound to erode taxpayer confidence and discourage voluntary compliance.

With the lowering of tax rates on personal and corporate incomes, the provision for charging additional income tax on undistributed profits had lost its significance and its deletion has been rightly proposed. The tax concession presently available to domestic companies earning income from a foreign government or a foreign enterprise for importing technical know-how is sought to be given only if the foreign exchange earned is repatriated to India within the specified period. In line with this suggestion, it is also proposed that 50% of the remuneration received in foreign exchange by an Indian citizen for services rendered abroad or 75% of such remuneration as is repatriated in convertible foreign exchange, whichever is higher, will be allowed as a deduction.

In keeping with an earlier announcement, depreciation rates are being liberalized with effect from 2 April 1987, there being only 3 rates for plant and machinery, namely 100%, 50% and 33⅓%.

Mention may be made of a proposal for deduction of tax at source from all payments, above prescribed limits, made to a resident by persons, other than individuals and Hindu undivided families, for professional and technical services, royalties, rent, commision or brokerage and payments for goods supplied to Government bodies, local authorities and companies. For example, tax at 10% will be deductible if the annual rent payable exceeds 36,000 Rs., but not 48,000 Rs.; on the balance the proposed rate is 20%. For supplies of goods worth over 100,000 Rs. tax is proposed to be deducted at the rate of 5% by the purchaser. A close examination shows the suggestion to be a product of immature thinking. The monetary limits are too low and have apparently missed statutory deductions and allowances. The high tax rates are unimaginative. If deduction of tax at source is made, as proposed, hundreds of thousands of claims for tax refunds will arise; the likely hardship is too obvious to need elaboration. Superannuated individuals having income from rent, brokers and suppliers of goods will have to file tax returns and pursue refund applications. The tax department will not have the necessary administrative capability of refunding the excess tax deducted at source with expedition nor will the department have the requisite facilities for issuance of statutory certificates for no deduction of tax or deduction at lower rates. The paper work involved will lead to chaotic conditions in trade and industry. It is pertinent to note that the existing provisions in the tax law stipulate much lower rates of 2% and 1% for contractors and sub-contractors. The proposal needs serious reconsideration and the Prime Minister has already promised a review. The raising of thresholds for tax deduction at source from dividend and interest income to 2,500 Rs. is however a step in the right direction.

It ill behove the Prime Minister to introduce discriminatory legislation, favouring employees in the public sector undertakings. It has been suggested that any payment received by an employee of a public sector unit at the time of voluntary retirement should be fully exempt from tax, but no such exemption is available to employees of private sector companies. Likewise, a Government employee or an employee of a public sector undertaking can obtain relief under section 89(1) of the Income-tax Act, relating to tax on salary received in arrear or in advance, from the employer, but the employee of a private sector undertaking has to apply for a refund from the Income-tax Officer and suffer harassment. This unjustifiable distinction should be removed. It is proposed to enhance the existing permissible deduction of 10,000 Rs. to 15,000 Rs. in the case of totally blind or otherwise permanently disabled individuals.

In the field of indirect taxes, it is proposed to extend MODVAT (modified value added tax) to all the chapters of excise tariff except those relating to textiles, tobacco and the petroleum sectors. The scheme is also

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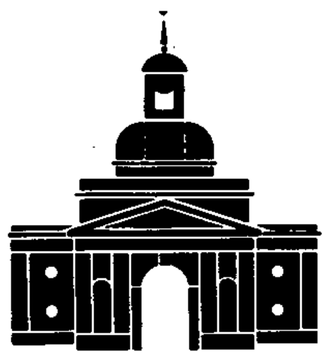
being simplified and several concessions are intended to avoid the cascading effect of excise duty. Certain changes have been proposed in import duties for the benefit of the indigenous capital goods industry. Duty on textile plant and machinery has been substantially cut from 245% to 65% and the import duty on foundries has also been reduced. The Prime Minister has shown special interest in computers, electronics and automobiles and, presumably, the revision of rates is in consonance with his own objectives.

Reference may be made to a proposed 15% tax on foreign exchange released for foreign travel excluding travel for education, medical treatment and perhaps pilgrimage abroad. Users of luxury hotels may be subjected to a special tax of 10% for which a comprehensive scheme will be worked out.

To conclude, Mr. Gandhi's maiden Budget unfolds a mixed bag of tax proposals, good, bad and indifferent. These will have no impact on industrial growth, but may have an adverse effect on his Government's credibility. Together with the whopping allocations for non-productive expenditure, including defence, record deficits, the ever present threat of a double-digit rise in the consumer price index and mediocre tax proposals bode ill for the future of the country's economic development.



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INDIA:

Losses May Be Set Off against Foreign-source Dividends Exempt under a Tax Treaty

Decision of the Supreme Court of India in CIT v. Mahalaxmi Sugar Mills Ltd. (1986), 160 ITR 920 (S.C.)

By Nandita Sen

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INTRODUCTION

A recent judgement of the Supreme Court of India interpreting the (old) bilateral tax treaty between India and Pakistan may raise some concern on whether the protection from double taxation ensured by a treaty for the avoidance of double taxation can be whittled down by the application of the domestic laws of a country. The judgement may be significant for taxpayers of other countries too as it may be adopted as a precedent and have some persuasive force for the tax authorities and courts of law in other countries.

THE ISSUE

The case in question relates to an assessee: an Indian public company, carrying on business for the manufacture and sale of sugar in India. The company also held some shares in a sugar and distillery company in West Pakistan. The relevant year of assessment was 1957-58. In this year the assessee company incurred losses in its business in India while it received a substantial amount of dividend income from its investments in West-Pakistan.[1]

The assessee contended that in determining the total world losses for carry-forward under the Indian Income-tax Act, 1922, the dividend income earned in Pakistan could not be offset as such dividend income was not subject to tax at all in India by application of the provisions of the tax treaty between India and Pakistan. The Revenue Department and the Income Tax Appellate Tribunal rejected the assessee's contention.

HIGH COURT'S ANALYSIS – SUPPORTING ASSESSEE

The Delhi High Court examined whether the Tribunal was right in holding that the dividend income from Pakistan was deductible in arriving at the total world losses of the assessee for carry-forward under Section 24(1) of the Indian Income-tax Act, 1922. The High Court relied on the decision of the Supreme Court of India in *Indore Malwa United Mills Limited v. CIT*[2] which had held that losses incurred in Indore (then an independent State outside the taxable territories of India) and carried forward under the provisions of the Indore taxation laws, could not be considered for offset against income earned by the assessee in India, i.e. after the State was merged with India and became a part of the Indian taxable territory. On application of this principle to the present case, dividend income earned in Pakistan could not be considered for set-off against losses sustained in India.

The High Court was also of the view that since according to the provisions of the Schedule to Article IV of the tax treaty between India and Pakistan[3], each country had the authority to tax such amount of the dividend income as was in proportion to the profits of the company paying the dividends (taxable in such country) no portion of the dividend income in this particular case could be taxed in India nor could it therefore be considered for determining the quantum of world losses for carry-forward by the assessee under Section 24(1) of the Indian Income-tax Act.

Contents

Introduction
The issue
High Courts's analysis – Supporting assessee
Supreme Court's contentions – Rejecting assessee's claim
Some open-ended questions

1. East-Pakistan is now Bangladesh.
2. (1962) 45 ITR 210 (S.C.).
3. Not in operation from 1971-72.

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The High Court was further of the view that the effect of setting off the dividend income against the assessee's losses in India would amount to denying the assessee of the benefit of exemption in respect of the dividend income arising in Pakistan. Consequently, it would deprive the assessee of the right of having its entire losses carried forward to the next year. Such an indirect taxation would not be permissible. "If a rule would have the effect of indirectly depriving the company of any part of the benefit of the exemption . . . its operation must be cut down and allow the exemption to operate to its full extent."[4] The High Court thus reversed the decision of the Tribunal and held in favour of the assessee.

SUPREME COURT'S CONTENTIONS – REJECTING ASSESSEE'S CLAIM

The matter came up before the Supreme Court of India for a decision on the very important issue of the scope and effect of the provisions of the bilateral treaty vis-à-vis that of the respective tax laws of the treaty countries.

Examining the "Agreement for Avoidance of Double Taxation between the Government of the Dominion of India and the Dominion of Pakistan" in operation in the relevant assessment year (1957/58), the Supreme Court reaffirmed its view (taken earlier in *Romesh R. Saraiya v. CIT*)[5] that the double taxation avoidance agreement had no role to play in the matter of determination of total income of an assessee by application of the domestic laws of India. The Supreme Court proceeded with the analysis of the material provisions contained in Articles IV, V, VI and VII of the treaty as set forth below:

> *Article IV.* – Each Dominion shall make assessment in the ordinary way under its own laws; and, where either Dominion under the operation of its laws charges any income from the sources or categories of transactions specified in column 1 of the Schedule to this Agreement (hereinafter referred to as the Schedule) in excess of the amount calculated according to the percentage specified in columns 2 and 3 thereof, that Dominion shall allow an abatement equal to the lower amount of tax payable on such excess in their Dominion as provided for in Article VI.
>
> *Article V.* – Where any income accruing or arising without the territories of the Dominions is chargeable to tax in both the Dominions, each Dominion shall allow an abatement equal to one-half of the lower amount of tax payable in either Dominion on such doubly taxed income.
>
> *Article VI.* – *(a)* For the purposes of the abatement to be allowed under Article IV or V, the tax payable in each Dominion on the excess or the doubly taxed income, as the case may be, shall be such proportion of the tax payable in each Dominion as the excess or the doubly taxed income bears to the total income of the assessee in each Dominion.
>
> *(b)* Where at the time of assessment in one Dominion, the tax payable on the total income in the other Dominion is not known, the first Dominion shall make a demand without allowing the abatement, but shall hold in abeyance for a period of one year (or such longer period as may be allowed by the Income-tax Officer in his discretion) the collection of a portion of the demand equal to the estimated abatement. If the assessee produces a certificate of assessment in the other Dominion within the period of one year or any longer period allowed by the Income-tax Officer, the uncollected portion of the demand will be adjusted against the abatement allowable under this Agreement; if no such certificate is produced, the abatement shall cease to be operative and the outstanding demand shall be collected forthwith.
>
> *Article VII.* – *(a)* Nothing in this Agreement shall be construed as modifying or interpreting in any manner the provisions of relevant taxation laws in force in either Dominion.
>
> *(b)* If any question arises as to whether any income falls within any one of the items specified in the Schedule and if so under which item, the question shall be decided without any reference to the treatment of such income in the assessment made by the other Dominion.

The Schedule
(see Article IV)

Source of income or nature of transaction from which income is derived	Percentage of income which each Dominion is entitled to charge under the Agreement		Remarks
1	2	3	4
8. Dividends	By each Dominion in proportion to the profits of the company chargeable by each Dominion under this Agreement.	(As in preceding column.)	Relief in respect of any excess income-tax deemed to be paid by the shareholder shall be allowed by each Dominion in proportion to the profits of the company chargeable by each under this Agreement.

Having regard to the opening lines of Article IV of the treaty, the Supreme Court held that it clearly indicated that each Dominion could assess "in the ordinary way under its laws" regardless of the existence of the agreement.

Article VI provided that where at the time of assessment in one "Dominion"[6] the tax payable in the other

4. Relying on the Court of Appeal in *Australian Mutual Provident Society* v. *Inland Revenue Commissioner* (1946)/All ER 528, 53 (C.A.).
5. (1965) 55 ITR 699 (S.C.).
6. With "Dominion" either one of the countries, India or Pakistan, is meant.

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is not known, the first Dominion would make a demand without allowing any abatement but hold a portion of the demand representing an estimated amount of abatement in abeyance for future adjustment after the quantum of abatement is known and established. This also led to the same conclusion that an assessment under the local laws of the treaty countries is independent of the provisions of the treaty. A question of making a demand in the first place and then allowing an abatement later could only arise if an assessment was validly possible.

Article VII was more direct in stating that "nothing in this Agreement can be construed as modifying . . . in any manner the provisions of the relevant taxation laws in force in either Dominion". The treaty does not nullify the provisions of Section 24(1) of the Indian Income-tax Act, 1922, nor does it modify the provisions. It is by operation of the agreement that the dividend income is made chargeable entirely in the Dominion of Pakistan. If regard is had to the provisions of the Indian Income-tax Act, 1922, without reference to the agreement, the dividend income, even though accruing or arising abroad, would become subject to tax for a "resident" in India by virtue of Section 4(1) of the Indian Income-tax Act.

Section 24(1) of the Indian Income-tax Act, 1922 (reproduced below) signifies that losses of any year under any "head" (i.e. category) of income (as distinguished in the law) are to be set off against the income under any other head *in that year.*

> 24. Set-off of loss in computing aggregate income
> (1) Where any assessee sustains a loss of profits or gains in any year under any of the heads mentioned in Section 6, he shall be entitled to have the amount of the loss set off against his income, profits or gains under any other head in that year.

Sub-section (2) of Section 24 further provides that it is only so much of the business loss as cannot be set off against the provisions of sub-section (1), that would be carried forward to the following year. The Supreme Court was of the view that the method of computation of losses for carry-forward under Section 24(1) read with 24(2) remained unaffected by any provision of the treaty.

The Supreme Court reversed the verdict of the Delhi High Court holding that the tax treaty in no way restricted the power of any of the parties to the treaty (India and Pakistan) to assess in the normal way all the income that was liable to taxation under their respective laws. What the treaty sought to provide is a right of abatement to the taxpayer for income doubly taxed in both countries. The tax treaty in fact prevented both the countries from retaining any part of the tax for which abatement was due to the assessee. According to the Supreme Court, the High Court had "fallen into the fallacy of treating the setting-off of the dividend income against business loss as an infringement of the agreement".

The Supreme Court decision can be summarized as follows:

(a) The double taxation avoidance agreement preserves the right of each country to determine the assessable income in accordance with the laws in operation in the respective countries.

(b) The treaty is only concerned with power of retention of the right amount of tax by each country as per schedules given in the treaty.

(c) Assessment under the laws of either India or Pakistan have to be made in the ordinary way and consequential tax liability determined (it was only thereafter that the treaty took over and came into play).

(d) There was no provision in the Indian Income-tax Act by which it could be inferred that the dividend income was not liable to inclusion in determining the total income of the assessee in India.

(e) Consequently, for purpose of carry-forward of losses under Section 24(1) for set-off against profits of future years, dividend income from the Pakistan company was deductible from losses sustained in India.

SOME OPEN-ENDED QUESTIONS

The Supreme Court judgement as reported leaves a feeling that the Court was primarily concerned with the mechanics of application of the treaty vis-à-vis the domestic tax laws rather than the intent and purpose behind the tax treaty. The reason may be that a number of relevant issues were not raised before the Supreme Court for examination. The judgement also leaves many pertinent questions unanswered. For example:

- Why does the Supreme Court not consider the ratio of its earlier decision in *Indore Malwa United Mills Limited*[7] as applicable to the present case?
- How would the Court meet the argument of the Delhi High Court in the overruled judgement[8] that the setting off of the dividend income arising in Pakistan against losses in India results ultimately in taxing the dividend income from Pakistan in India?
- How would the Supreme Court counter the principle laid down in *Australian Mutual Provident Society*[9] that "if an exemption is conferred, the Crown must not get the tax relief either directly or indirectly . . . In so far as the rule, if taken in isolation, would have the effect of indirectly depriving the company of any part of the benefit of the exemption, its operation must be cut down and allow the exemption to operate to its full extent"?

The Supreme Court decision seems to have considered Articles IV to VII of the bilateral treaty and the provisions of Section 24 of the Indian Income-tax Act, 1922 in isolated pockets and arrived at a result which indirectly leads to curtailing the benefit that the treaty precisely wishes to confer. It is not unlikely that the ratio of the judgement may be reversed in the future, as there is an apparent inconsistency between the intent and purpose of the treaty and the result that is achieved by virtue of the manner of its application.

7. See note 2.
8. See note 5.
9. See note 4.

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JAPAN:

Ongoing Tax Reform II

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I. THE REPORT OF THE TAX COMMISSION

1. Underlying philosophy

On 28 October 1986, at its general meeting, the Tax Commission approved a report on the overall review of the tax system, which was subsequently submitted to Prime Minister Yasuhiro Nakasone. The review is based on the principles of equity, fairness, simplicity, choice and economic vitality – taking into consideration the neutrality to resource allocation and the international context.

The social and economic climate of Japan has drastically changed since the current tax system was introduced in 1950. Because the existing tax regime no longer reflects the economic and social realities of today's Japan, it is no wonder that taxpayers have many complaints about unfairness and inequities in taxation. To mention a few, the size of the Japanese economy in terms of gross national product (GNP) has grown by 80.4 times between 1950 and 1985 or from 1/26th that of the United States to about one-third. Nominal national income per capita increased from 41,000 yen in 1950 to 1,978,000 yen in 1984 or from 1/14th of that of the United States to 2/3rds. According to a family budget survey, the income of the first quintile of the total families relative to that of the fifth quintile was halved from 5.8 times in 1950 to 2.9 times in 1985. The comparable figure indicative of the income differential between the low and high income classes is 9.1 times that in the United States in 1984. Obviously, Japan has one of the narrowest bands of income gap in the world.

In light of the recent improvement and leveling of people's living standard, it is of vital importance to seek a broader but lighter share of taxes among the people by expanding the tax base. A tax system which may serve this purpose should be logically simple and intervene minimally in the economy, thereby contributing to vitalization of the economy. In radically re-evaluating the tax system, it is also important to work out comprehensive and consistent proposals including reduction and rationalization of tax burdens and consolidation of financial resources. The tax reform should aim at correction of distortions and the mitigation of heavy tax burdens rather than at an increase in tax revenues. On the other hand, in view of the current level of tax burdens and the Government austerity programme, it should not reduce tax revenues, leaving a financial burden to the future generations. In other words, the reform is designed to be revenue neutral not only over a long period of time but also in each fiscal year until it is completed.

2. A desirable tax structure

In these days of a diversified and sophisticated socio-economy, if past experience is any guide, it is next to impossible to achieve equality in tax burdens and all other ideals of the tax system by any single kind of tax alone. Too heavy a reliance on one specific type of tax for Government revenue prevents fair sharing of tax burdens, thereby adversely affecting the national economy. Therefore, it is essential to build up a well balanced tax structure by judiciously combining income, consumption and assets as a tax base.

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Also important is improvement of the climate for tax compliance. By its very nature, the self-assessment system in Japan depends on the compliance of taxpayers. It should be promoted by winning the confidence and understanding of the general public through equitable taxation at both levels of institution and enforcement. Last but not least, due consideration should be given to the allocation of financial resources between the national and local governments so that the financial management of both entities may not be significantly affected by any change in tax revenues.

II. INDIVIDUAL INCOME TAX

1. Perception of tax burden

From the macro-economic point of view, the burden of the individual income tax in Japan is on the low side as compared with those of other industrial countries. The individual income tax as a percentage of personal income was 4.9% (7.1% including local inhabitants tax) in Japan, 12.1% in the United Kingdom, 5.0% in France in 1984, 10.1% (12.1% including local taxes) in the United States and 8.7% in the Federal Republic of Germany in 1983. Nevertheless, the Japanese taxpayers harbour a strong feeling of heavy tax burden. This is most apparent in the middle-income group who perceive distinct inequalities in the tax burden borne by wage earners as opposed to other taxpayers.

2. Rate structure

The steep progressive structure of tax rates prevents people from experiencing noticeable improvement in their living standard despite an increase in their income. Today, thanks to a more evenly distributed and higher standard of income, the majority of taxpayers come under a certain range of income brackets. At the same time, the social security programmes have been fairly well developed. Under the circumstances, while paying the deserved attention to the re-distributional function of the income tax, the progressivity may be somewhat moderated for the income brackets where most taxpayers are concentrated.

In order to keep salaried workers within a given tax bracket, a basic tax rate of 10% or 15% will be established for taxpayers who earn between 8 and 9 million yen. This bracket will include the majority of salary earners.

The local inhabitants' tax is designed to distribute the costs of maintaining local communities among the residents according to their abilities. Its minimum and maximum rates will be changed from the current 4.5% to either 5% or 4% and from 18% to 15%, respectively, and the number of brackets will be reduced from the existing 14 to 4.

3. Level of employment income deduction

The mechanism of the present deduction for employment income is something unique to Japan. Some observers see little or no need to raise the level of such employment income deduction since it has already reached, as far as the statistics on macro-data bear out, a height of about 30% of income from wages and salaries. But others argue that it may be expanded with due regard had to the proposed reduction in income tax rates. The Tax Commission's report analyzes four combinations of the tax rate schedules and employment income deduction. Salaried workers who account for a greater part of taxpayers are dissatisfied with the existing employment income deduction which is generally considered high enough. The reasons for their discontent are as follows: (i) the nature of this deduction is not necessarily clear; (ii) the costs actually incurred cannot be deducted; and (iii) salaried taxpayers whose tax is withheld at source have no chance to file a tax return of their own – calculating their tax base and tax amount.

To solve the problems, the following is suggested:

(1) For the purposes of clarifying its character, the employment income deduction will be divided into a standard deduction for employment work and a special deduction to adjust the burden of the tax to that placed on other incomes.
(2) Employees may opt to claim a deduction for expenses which they incur for employment by filing a final return.
(3) A distinction will be made in the employment income deduction between ordinary income from wages and salaries and a sole proprietor's income in the case where an election has been made to be treated as a corporation for income taxation purposes.

4. Personal deductions

Since the minimum taxable income is now set at an appropriate level, the basic personal deductions contributing to such taxable income may be kept intact.

With respect to the issue of the "unit" which must file a return, the splitting of income between a husband and his spouse has not been adopted. However, for a single-earner couple, in recognition of the contribution to earnings of the family by the spouse not directly engaged in income-earning activity and in order to ease the tax burden of the family, a newly created special deduction for the spouse of 150,000 yen for the national income tax and 120,000 yen for the local inhabitant tax will be added to the existing deduction for the spouse.

A spouse or dependent with income up to a certain amount is treated in the same way as a person without income and is entitled to an exemption to ease the administrative burden. A new subject of discussion in Japan is the loss of the spousal exemption when the income of a housewife from a part-time job exceeds a prescribed amount, hence, the after-tax income of her family decreases. To accommodate this situation, a formula, regular and special, will be introduced to

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adjust the exemptions for the spouse according to the income.

On top of this, in the interest of simplicity in the tax system, an attempt will be made to abolish the aggregation of family income from assets and to rationalize a variety of deductions from taxable income such as deduction for medical expenses.

5. Taxation of pensions

Because of the rise in the average age of the population, pension programmes play an increasingly important role in the national economy from the collection of the premiums to the payment of benefits. Accordingly, taxation on pensions should be streamlined. At present, the employment income deduction and the special deduction for the elderly are applicable to public pension benefits. However, the employment income deduction is designed for wages and salaries. With income from other sources, some recipients of public pensions are high-income earners. Therefore, it is not always reasonable to apply both deductions to income from public pensions. It is proposed that a new deduction for public pensions replace the existing two deductions while at the same time increasing the current deduction for the aged. Reassessment will be made of the taxation on benefits from employer-maintained pensions.

The individual pension programme under which beneficiaries receive the principal and interest of the contributed fund in the form of an annual pension is basically a savings account. The wealthy can afford to hold more individual pensions. If beneficiaries receive the principal and interest by withdrawal, the individual pension will be the same as an ordinary savings account. Taking this into consideration, the preferential tax treatment for the individual pensions should be re-evaluated from the standpoint of equality of burden and neutrality of taxation.

6. Taxation on interest and dividends

An in-depth review of the taxation on interest and dividends is one of the most urgent tasks of the ongoing tax reform. As a relief for small savings accounts, interest income from deposits in financial institutions, postal savings and Government bonds each with a total principal value not exceeding 3 million yen is exempt from tax. In addition, interest income from deposits under the savings programme for the formation of employees' assets with the principal not exceeding 5 million yen is also exempt from tax. These add up to a tax exemption for interest on savings when the principal is not over 14 million yen for each person. Incidentally, in 1985 the average savings of a wage earner family, including life insurance, was 6,920,000 yen.

As of the end of March 1986, tax exempt savings amounting to 287 trillion yen accounted for 60% (70% if insurance is excluded) of the overall savings of individuals totaling 503 trillion yen. As a result, during 1984 the tax-exempted income from interest totalled some 13.5 trillion yen, as against the taxable business income of about 8.7 trillion yen and taxable corporate income of 27.2 trillion yen. These compare with the tax-free interest income, taxable business and corporate income of 499 billion yen, 1,287 billion yen and 3,007 billion yen, respectively, in 1965. This reveals that the relative size of the privileged savings has grown spectacularly and that the high-income earners are making the most of the tax exemption system originally intendend for small savers. At the end of March 1985, as many as nearly 259 million returns were filed for a tax-exempt savings account and there were 394 million postal savings accounts, more than 3 times the entire population of the country. This is a glaring case of abuse of the tax exemption for small savings accounts as a tax shelter. One taxpayer has multiple tax-free savings accounts in different institutions and numerous such accounts are opened under an assumed name.

In 1980 legislation was passed to create a card system for savers of small amounts, commonly known as the "green card", which was scheduled to come into force from 1983. This card was designed to identify a saver for the sake of stricter control over small savings accounts. The proposed system met with a storm of opposition from various quarters. In 1983, the enforcement of the system was postponed for 3 years and in 1986 the ill-fated green card system was repealed without ever having been implemented. Instead, as from 1 January 1986, administration of the tax-free savings accounts has been reinforced, centering on more scrupulous identification of savers. Furthermore, gone are the days when saving was encouraged by all means. The Japanese are well known for their high rate of saving for one reason or another. Of late, the excess saving relative to limited investments in Japan is even blamed for the economic friction with the United States and the European Community nations.

It should be noted that, with a view to relief for the seriously affected persons with diminished earning ability, the tax exemption system for small savings accounts may be continued for elderly people and fatherless families.

The following 4 methods are suggested as alternatives to the tax exemption system for small savings accounts: (1) interest is subject to withholding tax at source and income tax is imposed on the aggregate amount of all types of income including such interest income; (2) tax is withheld on interest at source and no final return is required for interest income up to a certain amount; (3) withholding tax at a lower than normal rate is levied on interest, up to a certain amount, separately from other income; and (4) tax at a flat rate on all interest is withheld at source separately from other income. Many members of the Tax Commission endorsed alternative (4) because it is well adapted to the peculiarities of interest income and meets the requirements of simplicity, neutrality and efficiency. A considerable number of the members were in favour of (3)

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combined with (4) from the standpoint of fairness and equity in taxation. Some members supported alternative (2).

With regard to the local inhabitants' tax, the following 3 methods were studied: (1) a method corresponding to that of the national income tax; (2) separate taxation at a certain rate regardless of the method for the national taxation; and (3) inclusion in the national tax of the local tax which will be later given to local governments as a local transfer tax. Reassessment should also be made of a variety of financial instruments and the like, the income from which is not treated as interest income for taxation purposes. Classification of income, application of special deductions and introduction of withholding of tax at source should be considered in light of tax equity on interest and actual conditions in the markets.

7. Taxation on capital gains

At present, capital gains on securities held by individuals are exempt from tax except for those securities continuously traded. Taking into consideration fairness and equity when taxing interest and dividends on one hand and the possible impact on the securities market on the other, taxation on such capital gains should be gradually increased. The tax base should be broadened to pave the way to eventual overall taxation on capital gains.

In view of the fact that a good part of capital gains from land are not taxed as a result of various special deductions and favourable treatment for the exchange of property, expansion of the tax base should be seriously considered.

Also, an attempt should be made to reduce various tax privileges which are no longer necessary nor appropriate in the light of the intended policy objectives.

III. CORPORATE TAX

1. Level of tax burden

Since the late 1960s, the corporate income tax rate has steadily risen in order to meet the fiscal demand. As a result, the effective tax rate, which was around 40% from 1950 through 1970, has now risen to 52.9%. This is higher than the 51.18% rate (40.34% in and after July 1987) of the United States, the 35% rate of the United Kingdom and the 46.5% rate of France. Only the Federal Republic of Germany is higher with a rate of 56.52%. These rates are derived by the Japanese Ministry of Finance by combining various domestic taxes.

These days, the Japanese society and its economy are closely related with those of other countries. It would be destabilizing if there was a substantial difference in tax burden on corporations in Japan as opposed to other advanced nations. Businesses might shy away from Japan if the tax burden was too heavy, thus accelerating the hollowing-out or outsourcing of industries.

It may be remembered that other industrial economies are lowering the tax rates while broadening the tax base for the corporate tax. Paying due attention to the status of Government finances, it would be appropriate to reduce the effective tax rate to below the 50% level in the medium term.

2. Rate structure

As far as the corporation tax is concerned, the case for progressive tax rates has been dismissed since it will adversely affect the enterprises which require by their nature of business a huge amount of capital and, hence, income available for distribution as dividends.

A reduced tax rate was first introduced in 1955 to relieve small businesses of their tax burden. Since then, the reduced rates were cut deeper than the basic rate and remained unchanged even when the basic rate was raised. In this way, the margin between the two has grown unevenly. At present, the reduced rate is 31% for companies with capital less than 100 million yen and annual income not exceeding 8 million yen, as against the basic rate of 43.3%. While taking note of the rationale of the lenient tax treatment for small firms, the differential between the basic and reduced rates should be somewhat lessened.

3. Adjustment of tax burdens of individual and corporate taxes

In Japan the double taxation on income both at the corporate and individual levels is adjusted mainly by means of the tax credit for dividends received by shareholders. In 1961, the split tax rate system on corporations was added to the mechanism of adjustment. At present, 10% (5% of that part of the total taxable income which exceeds 10 million yen) of dividends may be credited against a shareholder's income tax. The retained income of corporations is taxed at 43.3% while distributed income is taxed at the reduced rate of 33.3%.

Despite some dissenting opinions, measures for adjustment of individual and corporate income taxes are considered necessary because income of corporations is in the final analysis attributable to shareholders and constitutes a part of their personal income. The existing mechanism of adjustment at both the corporate and the shareholder levels is too complicated. As is often the case with Japan, where the prime concern of entrepreneurs is to maintain the certain established rate of dividends, the reduced tax rate on corporations is not necessarily conducive to increase dividends and, hence, shareholders do not benefit from the alleviation of double taxation. The split rate regime was originally intended to make it easier for corporations to raise funds by equity since the tax on dividends is lessened. The ratio of owned capital to liabilities of corporations declined in the period of fast economic growth during

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the 1960s and 1970s and rose in one of stable economic growth during the 1980s. This implies that there is no appreciable correlation between the owned capital and the reduced tax on distributed income. Instead, the corporate tax amount differs depending on the propensity to distribute earnings thus casting a doubt on neutrality and fairness. Therefore, it is advisable to abolish the split rate system and to achieve integration of individual and corporate income taxes at the shareholders' level.

4. Inter-company dividends

Exclusion of dividend receipts from the taxable income of the receiving corporations was introduced in 1950. During the era of rapid economic growth, corporations had an increasingly important role to play in the economic activity. For companies listed on the stock exchange, the shares owned by corporations, as distinguished from individuals, as a percentage of the total shares, increased from 35.5% in 1950 to 74.4% in 1985. Taxation on dividends received by parent companies from their subsidiaries would encourage vertical integration of enterprises because branches are more advantageous for tax purposes than subsidiaries. This exerts a non-neutral effect on the form of business organization. Therefore, dividend exclusion may be kept for controlled companies. However, as far as the shares owned by corporations for investment purposes are concerned, dividend exclusion may be unnecessary in light of the situation of portfolio selection.

5. Tax base

(1) Principle

In reviewing the tax system, it is important to promote the vitality of the economy in the long and medium term and revitalize businesses by making the tax system neutral to economic activity against the background of internationalization of the Japanese socio-economy. In view of the current lack of Government finances the tax base should be substantially broadened while lowering the corporate tax rates.

(2) Tax-free reserves

The following most commonly used tax-free reserves should be reassessed for the purpose of broadening the tax base:

(a) The statutory percentage for the bad debts reserve has been adjusted from time to time. Nevertheless, it still deviates greatly from actual defaults.

(b) The reserve for retirement allowances was created to mitigate the tax burden when the corporate tax rates were sharply raised in 1952. With the approach of an aging society, the employer-maintained pension programme will be reinforced in addition to the public pension programme. Under the circumstances, this reserve should be reviewed, paying due attention to the effect on business management and the degree of the tax rate cut.

(c) Any change in the reserve for bonus payments does not seem to significantly affect business management since bonus payment occurs continuously and rather regularly – the reserve is drawn down in a relatively short time and the increase in labour cost is more moderate than before.

(3) Depreciation allowances

Thus far, taking into consideration the obsolescence caused by technological progress, depreciation of an individual asset has been reviewed in light of actual use. A survey has recently been conducted on the average period of use of machinery and equipment. It was found that there are discrepancies between the average period of actual use and the statutory useful life. But it is not to such an extent as may require serious reconsideration of the latter. It is also indicated this review is not consistent with the philosophy of a statutory useful life. The salvage value of the assets, which is now set at 10% of the acquisition cost, will not be reduced. This is because the depreciation would be accelerated in the initial period under the declining balance method if such salvage value is lowered.

(4) Special taxation measures

Since 1976 various tax incentive measures have been considerably curtailed. The favourable tax incentives which have already achieved their objectives or are of little use for policy purposes should be further consolidated and rationalized.

(5) Entertainment expenses

Traditionally, entertainment expenses have been tax deductible costs, however, because of abuse this has gradually altered to where they are now, in principle, non-deductible from taxable income. Small businesses are allowed to deduct a limited amount of such expenses. The existing tax treatment of the entertainment may be maintained and the amount allowed for small businesses should be reassessed.

(6) Foreign tax credit

Foreign tax credit was introduced in 1953 to eliminate the international double taxation on income and was expanded in 1962 by switching from the per-country to the overall limitation as the overseas activities of the Japanese firms substantially grew.

In these days of progressing internationalization of Japan, this gives rise to many problems in connection with the current system of foreign tax credit. The advantage of the overall limitation method is its simplicity and ease of calculation. However, the drawback is that even the foreign tax which is imposed at a higher rate than the effective rate of Japan can be credited. This tempts businesses to make investment designed to take advantage of such foreign tax credits. Under the present rule on allocation of revenues and expenses between those derived or incurred respectively

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within and outside Japan, a distinction between income from foreign and domestic sources does not really reflect the activities of firms. As internationalization develops, the problem is getting even more acute. It is necessary to strike a balance between administrative convenience and solution of the above-mentioned problem.

IV. ESTATE TAX

1. Inheritance tax

The inheritance tax has not been fully reviewed for more than a decade since it was amended in 1975. In light of the changing economic and social circumstances, the following are recommended:

The taxable minimum amount has been set at 32 million yen for three heirs and heiresses, including a surviving spouse, since the 1975 revision. It is appropriate to raise this amount in view of the recent economic indicators such as prices and income so that the propertied middle class may not suffer from too heavy a burden. At present, one-half the estate value or 40 million yen, whichever greater, is exempt from tax for a surviving spouse. It is proposed to raise this exemption. The tax rates are to be progressive ranging from 10% to 75% gradated by 5 percentage points. Some members of the Tax Commission argued that the maximum rate, one of the highest among the industrialized countries, be lowered and the number of the rate brackets be reduced in the interest of simplification. However, both will be kept intact because the inheritance tax functions for redistribution of wealth but, unlike the income tax, does not appear as a heavy tax burden every year.

The land in the taxable estate is grossly undervalued in the face of the recent soaring market prices of land. It is necessary to reassess the value of land for taxation purposes.

The gift tax, which is supplemental to the inheritance tax, should also be re-examined in parallel with the review of the latter with respect to the basic exemption and the rate schedule.

2. Fixed assets tax

The fixed assets tax (real property tax), which together with the inhabitants' tax are pillars of municipal taxes, share of total tax revenues is shrinking. Under the circumstances, an attempt should be made to make the assessment of assets more equitable and proper with a view to reinforcing the taxation of fixed assets. In doing so, however, care should be taken not to abruptly increase the tax burden. The low tax on farmland in urban areas has long been an eyesore to city-dwellers. Nevertheless, the measures adopted under the land tax reform of 1982 are still in the process of execution. It is too early to take any new steps for the sake of the stability of the tax regime.

3. Wealth tax

It may be remembered that the net wealth tax instituted according to the Shoup recommendations in 1950 was terminated in 1953 because of many difficulties in administration such as tracing and assessment of assets and the achievement of fair taxation. In spite of the criticism that the wealth tax is partly repetitive of the fixed assets tax and that fair and equitable enforcement of the relevant laws and regulations is hard, it would be worthwhile to study the wealth tax as a medium and long-term task.

V. INDIRECT TAXES

1. Basic principle

The fast economic development after the war and the subsequent stable growth have enhanced the income standard and realized the even distribution of income in Japan. Particularly, the remarkable improvement of the social security and welfare programmes since early 1970 has rendered the entire social life homogeneous. Thus, people are required to share the costs of the community in the form of a broad-based but low-rate tax. Direct taxes are characterized by progressivity commensurate with the increase of income while indirect taxes are basically equitable because they tax consumption from earnings. How to combine direct and indirect taxes is a matter of choice for the society and times.

2. The current status of indirect taxation

The coverage of the commodity tax and other indirect taxes in Japan is limited to certain specified commodities and services. In the past when the income level of the people was low and the income brackets of consumers and consumption of sumptuous goods and services were clearly correlated, such indirect taxation accurately reflected the tax-paying ability. However, now that the consumption of the general public has been well diversified, expanded and equalized, it is increasingly difficult to select taxable items and set appropriate tax rates. As a result, imbalance has surfaced between taxed and untaxed items as well as among those already subject to tax in an earlier stage.

Furthermore, in recent years, the economy is getting more service-oriented. Service industries have a far greater role to play in the economy than ever before. According to a family budget survey, expenditure on services as a percentage of the total final consumption rose from 42.4% in 1970 to 50.4% in 1984. Only a small portion of this is currently taxed. Thus, the system has failed to cope with the diversifying consumption patterns and the growing service industries. Some examples of the strange inconsistencies in taxable items are as follows: furs, golf equipment, surfboards, water skis, ordinary furniture, conventional television sets, coffee and cocoa are taxed, but high-class textiles

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(of wool or silk), tennis equipment, skis, paulownia-wood or lacquer furniture, liquid crystal television sets, and black and green tea are not.

In connection with indirect taxation, of the 23 members of the OECD Japan is the only nation that depends solely on the individual excise tax both at the national and local levels. Such tax on selected items is prone to criticism from abroad. A swelling bilateral trade disequilibrium has triggered the outcry that the liquor and commodity taxes are discriminatory against imports. The European Community contends that the ad valorem tax and the grade classification based on the content ratio of malt and grain of alcoholic beverages make European whisky more expensive than Japanese brands. The EC even threatened to take the dispute over Japan's liquor taxes to multilateral negotiations at the General Agreement on Tariffs and Trade (GATT). The United States complains that the ad valorem tax disfavours American wine export to Japan. Allegations are also made that the commodity tax discriminates against automobiles of the United States, gold coins of Canada and watches of Switzerland.

To increase tax rates or taxable items within the framework of existing indirect taxation would create more problems than it would solve and cannot be a realistic approach from the standpoint of securing revenue sources. If these problems are to be totally eradicated, a bold revamping unbound by the prevailing regime should be carried out. The most advisable replacement seems to be a new type of indirect tax which is, as a rule, applicable to all consumption unless specifically exempted.

3. Study of the new types of indirect tax

As mentioned earlier, in July 1986 the expert subcommittee of the Tax Commission proposed three types of new indirect taxes as follows:

A. Manufacturers' sales tax

All manufactured goods with exception of certain items, such as food products, would be subject to the tax, instead of a few selected items as now taxed in Japan. Raw materials, machinery and other goods used in the manufacturing process would be free from tax. Two options are suggested for this tax: (i) one with a list of tax-exempt items and (ii) the other without such list.

B. Tax on all business sales except on inter-firm transactions

This business sales tax is levied also on services. Social security services and food products are not subject to the tax. Most transactions between firms would also be exempted. Goods and services would be taxed only once between production and final retail to the consumer or small business.

C. Japanese-style value-added tax

This tax is imposed on the sales of products and services. Food and social security services are not taxed. Businesses would be taxed on their sales during a specified period. The amount of tax due is the difference between the tax computed on their sales and the tax on materials consumed in the manufacturing process. Taxes would be assessed on value-added at each of the manufacturing, wholesale and retail levels. The proposed tax is of the Japanese style in that, unlike the value-added tax in EC countries, it requires no issuance of an invoice for transactions which do not conform with the Japanese commercial practices.

The Tax Commission carefully evaluated these three types, A, B and C, comprising four options together with the wholesale tax, turnover tax and the general excise tax on the criteria of: (i) compatibility with Japanese business practices; (ii) simplification in the procedures both for tax collectors and taxpayers; and (iii) fairness and neutrality to economic activities, including avoidance of cumulative taxation and attainment of border tax adjustment. The findings of the Commission are set forth below.

Wholesale transactions in Japan are far more complicated than in foreign countries: the party actually paying the wholesale tax will be a large number of small wholesalers. Therefore, the wholesale tax does not suit Japan. The 1% turnover tax was put into effect in July 1948, soon after the war, but was abolished after only 18 months because of many shortcomings. The Japanese people's unhappy memory of this short-lived tax should not be ignored. The tentatively named "general excise tax", recommended in the report of the Tax Commission in 1978, adopted a formula of subtracting prior-stage taxes on purchase of goods without recourse to vouchers. Unfortunately, however, its mechanism was not well understood by the general public. Thus, it does not deserve further consideration by the Commission. Consequently, more serious studies were made of the newly proposed three types.

A. Manufacturers' sales tax
This tax is relatively easy to manage because the number of taxpayers is small and, in particular, retailers, who are mostly small, are excluded. People should be readily familiar with the tax because it has something in common with the existing commodity tax. However, the problem is that services, which are increasingly important in today's economy, would not be covered. Since the tax base is narrow, the tax rate must necessarily be high to yield the needed revenues. Because manufacturers are taxed, the tax is not neutral to the economy and industries.

B. Sales tax with exemption for inter-firm transactions
The tax base is wider than that of alternative A because services are included, however, the number of taxpayers will be smaller than that of alternative C because it is levied at a single stage. One of the demerits,

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however, is that the final tax burden differs depending on the stage at which the tax is assessed.

C. Japanese-style value-added tax
This tax is of a most logical nature and neutral to the economic activity because the tax is divided and collected at each stage of transaction including provision of services. Another merit is that the tax burden may be easily shifted by means of crediting taxes. On the other hand, however, the disadvantage is that it would involve a huge number of taxpayers. Everything considered, the report of the Tax Commission concluded that proposal C is the best as an apparatus for the new indirect tax. Many members were of the view that it is most desirable to introduce C since it fits well with the tax climate of Japan. Some members suggested to employ alternative A for the time being and others referred to variations or modifications of these three alternatives. The report adds that in making a final decision on the kind to be introduced, due regard should be had to the trend of public opinion.

4. Reconsideration of the existing indirect taxes

In principle, the present commodity taxes are to be absorbed in the planned new indirect tax. However, it is unavoidable to apply higher-than-basic rates to the new indirect tax or to levy extra charges on certain commodities which are now taxed at higher rates. When it comes to non-essential things such as liquor and tobacco, in those countries which have a broad-based indirect tax, they are subject to both such indirect tax and excise tax. It is desired to adjust the tax burden on these luxuries even after the institution of the new indirect tax. It is also pointed out, in connection with the revision of the liquor tax, the issues of grading of alcoholic beverages and tax rates for different grades should be reviewed.

The transfer taxes such as stamp tax and securities transaction tax are based on the tax-bearing capacity underlying the transfer of properties. They should stay apart from the planned indirect tax of a new type. As a matter of course, other indirect taxes should be integrated into the new indirect tax in the interest of a simpler tax system.

VI. EFFECTS OF THE TAX REFORM ON THE ECONOMY AND HOUSEHOLDS

In the course of its deliberation, the Tax Commission estimated the possible effects of the envisaged tax reform assuming reduction of the individual and corporate income taxes, change in taxation on interest and introduction of the new indirect tax.

As for the effects of the national economy, on the demand side the tax overhaul will be neutral or will have a positive effect to some extent. On the structural or supply side, moderation of the progressivity of the individual income tax and a cut of the effective rates of the corporation tax will stimulate labour supply and business activity in the medium and long-term period. If the reform further broadens the tax base and is more neutral to the economy, the economic vitality would gather greater momentum.

With regard to the impact on households, the report emphasizes the importance of adjusting the tax burdens to the differing earnings and expenditure at various stages in life from first employment and marriage to retirement. According to the estimates based on a family budget survey, the tax burdens on those in their forties or fifties will be reduced the most, on those in their twenties or thirties it will be reduced to a lesser extent, and on bachelors in their early twenties, in some cases, it will increase. For those in the age bracket of the first half of their sixties who have finished their prime service and are rehired, the income tax will be cut, but because of their high consumption relative to income, in some cases, the tax burden as a whole may be heavier. Those in the latter half of their sixties who are completely retired and live on a pension will enjoy a lighter tax burden.

Incidentally, in spite of the policy of neither gain nor loss in tax revenues of the national treasury under the prospective tax reform, the tax burdens would be lessened for many age-groups. This is because only that part of the burden of the forthcoming new indirect tax which may be directly reflected on the family budget is taken into account.

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SINGAPORE:

A Summary of the 1987 Budget's Tax Clauses

By Lee Fook Hong, MBA, FCIS, FAIA

The Minister for Finance, Dr. Richard Hu, presented Singapore's 1987 Budget to Parliament on 4 March 1987.

The few handouts this year for the business community were not unexpected in view of the generous incentives and concessions which were given out last year. Although temporary cost-cutting measures such as property tax rebates and reduction in employers' CPF contributions were not made permanent, the Minister did assure investors that the Government would not let costs rise out of line again. To back up the Government's new population policy, a very attractive incentive package was offered to Singaporeans having their third child. This year's Budget was generally regarded as fair and realistic by most business leaders.

The major changes are as follows.

I. COMPANY INCOME TAX

1. Withholding tax on margin deposits in financial futures and Loco-London gold trading

Effective from year of assessment 1988, the following interest paid by SIMEX members shall be exempt from withholding tax:

a. interest on margin deposits for transactions in gold and financial futures; and
b. interest in respect of transactions in Loco-London gold.

2. Extension of 10% ACU tax to securities trading

a. Securities companies approved by the Monetary Authority of Singapore (MAS) will be taxed at a concessionary rate of 10% on commission and fee income from transacting in non-Singapore dollar securities on behalf of non-residents.
b. ACUs and approved securities companies will be taxed at a concessionary rate of 10% on income derived from trading in non-Singapore dollar securities with non-residents, other ACUs and other approved securities companies.

The above incentives shall take effect from year of assessment 1988.

3. Tax incentives for promotion of offshore services

Effective from year of assessment 1988, the export incentive shall be extended to cover export of selected services such as consultancy, management, construction, technical and engineering services.

II. PERSONAL INCOME TAX

1. CPF minimum sum topping-up scheme

With effect from 1 April 1987 tax relief will be granted to individuals who use cash to top up the minimum sum accounts of their parents, subject to a maximum relief of $ 6,000 a year.

This incentive will also be extended to self-employed individuals who make cash contributions towards opening and topping up of the minimum sum account.

2. Tax incentives to encourage procreation

a. Normal child relief for third child will be increased from $ 500 to $ 750.

CHART I

Duties on cigarettes and tobacco

CCCN No.	Description	Existing import duty	Existing excise duty	New import duty	New excise duty
24.02 100	Cigars, cheroots and cigarillos	$ 60 per kg	$ 60 per kg	$ 70 per kg	$ 70 per kg
24.02 200	Cigarettes	$ 60 per kg	*$ 24 per kg	$ 70 per kg	*$ 34 per kg
24.02 400	Snuff	$ 60 per kg	$ 60 per kg	$ 70 per kg	$ 70 per kg
24.02 810	Other manufactured tobacco: Packed for retail sale	$ 60 per kg	$ 60 per kg	$ 70 per kg	$ 70 per kg
24.02 820	Not packed for retail sale: Pipe tobacco (bulk)	$ 60 per kg	$ 60 per kg	$ 70 per kg	$ 70 per kg
24.02 899	Tobacco not elsewere specified or included	$ 60 per kg	$ 60 per kg	$ 70 per kg	$ 70 per kg

* Excludes $ 36 per kg duty on tobacco used for the manufacture of cigarettes.

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CHART II

Duties on liquors

CCCN No.	Description	Existing import duty	Existing excise duty	New import duty	New excise duty
22.03 100	Beer and ale	$ 33 per dal	$ 22 per dal	$ 36 per dal	$ 25 per dal
22.03 200	Stout and porter	$ 45 per dal	$ 22 per dal	$ 48 per dal	$ 25 per dal
22.04 000	Grape must, in fermentation or with fermentation arrested otherwise than by the addition of alcohol	$ 187 per proof dal	$ 187 per proof dal	$ 360 per proof dal	$ 360 per proof dal
22.05 110*	Still wines exceeding 26% but not exceeding 42% proof spirit	$ 85 per dal	$ 85 per dal	No change	No change
22.05 120*	Still wines not exceeding 26% proof spirit	$ 55 per dal	$ 55 per dal	$ 85 per dal	$ 85 per dal
22.06 100**	Vermouths exceeding 26% but not exceeding 42% proof spirit	$ 85 per dal	$ 85 per dal	No change	No change
22.06 200**	Vermouths not exceeding 26% proof spirit	$ 55 per dal	$ 55 per dal	$ 85 per dal	$ 85 per dal
22.07 100	Cider and perry	$ 22 per dal	$ 22 per dal	$ 30 per dal	$ 30 per dal
22.07 200	Sake (rice wine)	$ 130 per proof dal	$ 130 per proof dal	$ 155 per proof dal	$ 155 per proof dal
22.07 900	Mead and other fermented fruit juices, vegetable juices and cereal beverages	$ 187 per proof dal	$ 187 per proof dal	$ 360 per proof dal	$ 360 per proof dal
22.08 100	Ethyl alcohol, undenatured, of a strength of 140% proof or higher	$ 280 per proof dal	$ 280 per proof dal	$ 360 per proof dal	$ 360 per proof dal
22.09 110	Brandy, in bottle, not exceeding 81% proof spirit	$ 210 per dal	$ 210 per dal	$ 270 per dal	$ 270 per dal
22.09 190	Other brandy	$ 280 per proof dal	$ 280 per proof dal	$ 360 per proof dal	$ 360 per proof dal
22.09 210	Gin, in bottle, not exceeding 81% proof spirit	$ 210 per dal	$ 210 per dal	$ 270 per dal	$ 270 per dal
22.09 290	Other gin	$ 280 per proof dal	$ 280 per proof dal	$ 360 per proof dal	$ 360 per proof dal
22.09 310	Rum, in bottle, not exceeding 81% proof spirit	$ 210 per dal	$ 210 per dal	$ 270 per dal	$ 270 per dal
22.09 390	Other rum	$ 280 per proof dal	$ 280 per proof dal	$ 360 per proof dal	$ 360 per proof dal
22.09 410	Whisky, in bottle, not exceeding 81% proof spirit	$ 210 per dal	$ 210 per dal	$ 270 per dal	$ 270 per dal
22.09 490	Other whisky	$ 280 per proof dal	$ 280 per proof dal	$ 360 per proof dal	$ 360 per proof dal
22.09 510	Liqueurs, in bottle, not exceeding 100% proof spirit	$ 210 per dal	$ 210 per dal	$ 270 per dal	$ 270 per dal
22.09 590	Other liqueurs	$ 280 per proof dal	$ 280 per proof dal	$ 360 per proof dal	$ 360 per proof dal
22.09 821	Vodka, in bottle, not exceeding 81% proof spirit	$ 210 per dal	$ 210 per dal	$ 270 per dal	$ 270 per dal
22.09 829	Other vodka	$ 280 per proof dal	$ 280 per proof dal	$ 360 per proof dal	$ 360 per proof dal
22.09 890	Other spirituous beverages not elsewhere specified	$ 280 per proof dal	$ 280 per proof dal	$ 360 per proof dal	$ 360 per proof dal
22.09 911	Compound alcoholic preparations in liquid form	$ 280 per proof dal	$ 280 per proof dal	$ 360 per proof dal	$ 360 per proof dal

* Merged into new code CCCN No. 22.05 100 with the description "Still wines, not containing aromatic flavour materials".

** Merged into new code CCCN No. 22.06 000 with the description "Vermouths, and other wines of fresh grapes flavoured with aromatic extracts".

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b. Eligibility for enhanced child relief will be lowered from 5 GCE "O" level passes to 3 GCE "O" level passes taken in one sitting.
c. Enhanced child relief will be extended to a new born fourth child. The amount of relief for the fourth qualifying child will be $ 750 plus 15% of the working mother's earned income, subject to a maximum of $ 10,000.
d. Special tax rebate will be granted for a new born third child. A tax rebate of $ 20,000 will be given and may be used to offset against either or both the husband's and wife's income tax liabilities. Where the wife is working, an additional rebate of 15% of the wife's earned income will also be given, but this rebate may only be used to offset against the wife's income tax liabilities. The excess of both rebates will be allowed to be carried forward for a maximum of four years.

The above incentives will take effect from year of assessment 1988.

III. OTHER TAX CHANGES

1. Duty on bets

Duty on bets will be increased, with effect from 1 April 1987, from 20% to 25% of the amount of bets made on any totalisator or pari mutuel promoted by any racing club or association.

2. Duties on cigarettes and tobacco

Effective from 4 March 1987, import and excise duties on cigarettes and tobacco have been increased from $ 60 per kilogram to $ 70 per kilogram.

3. Duties on liquors

Effective from 4 March 1987, import and excise duties have been increased from $ 210 per decalitre to $ 270 per decalitre. Details of increase in duties on beer, stout, etc. are shown in Chart II.

4. Surpluses of Statutory Boards

With effect from year of assessment 1988, Statutory Boards will be required to pay into the Consolidated Fund an amount equivalent to what they would have paid if their annual operating surpluses had been taxed at the corporate rate of 33%.

5. Tax on telephone services

Suspension of 20% tax on domestic telephone services and trunk call services to West Malaysia will remain for the time being.

6. Tax on public utilities

Suspension of 10% tax on electricity and gas has been extended until 31 March 1988.

7. Levy Scheme

a. All new foreign workers who are not Singapore permanent residents will be placed on the Levy Scheme. However, existing Malaysian workers who are on the CPF Scheme will remain on that Scheme so long as they continue to work for their current employers.
b. Levy for foreign workers in all sectors, except construction workers and foreign maids, will be $ 140 per month.

The above changes will take effect from 1 April 1987.

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COLOMBIA:

Tax Reform Changes to Existing Rules

By James Leavy

Several items mentioned in the article on new tax developments in the January 1987 issue of the *Bulletin* have been affected by the tax reform legislation summarized in the March 1987 issue.

1. THE TURGID HISTORY OF THE PETROLEUM REMITTANCE TAX

As indicated in the January issue of the *Bulletin,* Article 29 of Law 7 of 1986 re-established the remittance tax on amounts sent abroad by foreign petroleum companies, thus abolishing the exemption from that tax created by Law 9 of 1983 (Article 46(3)). However, Article 29 was successfully attacked in the Supreme Court as being unconstitutional since it was added to a public debt authorization statute on a proposal by a Congressman and not as a Government proposal.

The joy of the petroleum industry at the re-establishment of this cherished exemption was to be short-lived since Article 108 of Law 75 of 1986 specifically abrogates Article 46(3) of Law 9. The net result is that foreign petroleum companies operating in Colombia must pay a 30% remittance tax on branch profits, a 12% remittance tax on royalties or fees for technical services, and a 12% remittance tax on profits from participation in limited liability companies (sociedades de responsabilidad limitada) all of which are calculated on net amounts after deduction of any applicable income tax. However, in accordance with the general rule, dividends received by foreign petroleum companies from their shareholdings in corporations (sociedades anónimas) are not subject to remittance tax.

2. NEW TAX TREATMENT FOR FINANCIAL INCOME

Decree 870 of 1986, also discussed in the January 1987 issue of the *Bulletin,* became obsolete with the adoption of Article 27 of Law 75 of 1986. Decree 870 exempted certain percentages of financial income from inclusion as taxable income with a special percentage fixed for income from the UPAC system (essentially accounts in savings and loan associations). Law 75 provides that, for individual taxpayers, the inflationary component of financial income is not considered part of taxable income and abolished the distinction between income from the UPAC system and other financial income. The inflationary component is obtained by dividing the rate of monetary correction (i.e. an official measure of the loss of purchasing power of the peso) as of 31 December of the relevant fiscal year by the interest rate effectively received by the taxpayer.

In the case of corporate taxpayers, the reduction in the taxation of the inflationary component of financial income is gradual, being 10% of such component in the 1986 tax year. Decree 400 of 26 February 1987 has determined that the reduction in taxable financial income for the 1986 fiscal year will be 6.55% of the amount of such income.

3. NON-PROFIT ENTITIES AND "NEW TAXPAYERS"

As mentioned in the January issue of the *Bulletin,* there has been a change in policy with respect to the treatment of non-profit entities by the tax authorities. In virtue of Decree 1990 of 1986 such entities were for the first time obliged to obtain tax identification numbers and report all large donations received by them .

Law 75 has added many such entities to the roll of taxpayers, among them parent-teacher associations, civil defence organizations, alumni associations, hospitals, public improvement groups, employee pension funds, co-operatives, and non-profit entities which are engaged in financial intermediation activities.

In principle, these "new taxpayers" receive the same treatment as existing ones, but several special transitional rules are provided for in Decree 400 of 1987 in the case of investment funds and securities funds, which will be taxed only on their undistributed profits for 1986 if their profits for the 1986 fiscal year had been distributed before Law 75 entered into force on 23 December 1986.

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ARGENTINA:

Taxation of Royalties

By Máximo Bomchil (Jr.)

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I. INTRODUCTION

The legal framework in Argentina for the taxation of royalties and fees which originated in transfer of technology agreements, technical assistance and consultancy services was greatly amended by Law 23,260 of 11 October 1985 introducing modifications to the Income Tax Law (ITL) (text codified in 1986).

This article will deal briefly with different aspects of the amendment and in particular with the situation emerging for foreign licensors from countries with which Argentina has signed double taxation agreements (DTA).[1]

II. THE LEGAL FRAMEWORK

The taxation of income originating in transfer of technology agreements is governed principally by Article 93(a) of the ITL.

Until 1985 royalties and other remuneration paid for the use of industrial rights, know-how and technical assistance were taxed at a flat 18% rate on the gross amount when the transfer of technology agreements under which they originated complied with the provisions of the Transfer of Technology Law (TTL) 22,426 of 12 March 1981.

These provisions cover agreements executed between non-related parties, that is to say, between a local company and a foreign company not exercising effective control, who must be registered with the National Institute of Industrial Technology (INTI), for informational purposes. The registration is automatic, not requiring any governmental approval. Agreements entered into by a local company with a foreign company having effective control, are to be registered at the INTI only if previously approved by this governmental agency. Such agreements will be approved and registered if their terms and conditions adjust to normal market practices between independent parties.

Under the TTL, "transfer of technology" means the sale or licence of patents, industrial models and designs or any technological knowledge useful for the manufacturing of a product or the rendering of a service. The sale or licence of trade marks falls also under the scope of the TTL (Implementing Regulations, Decree 580/81).

The 1985 income tax amendment increased the tax rates on royalties and other remuneration for technology transfer considerably.

(a) Fees and other remuneration paid under technical assistance, engineering, and consultancy service agreements are subject to a 27% withholding on the gross if the agreements have been registered with the INTI, and the services effectively rendered cannot be obtained in the country, in the opinion of the implementing authorities (ITL, Art. 93(a)(1));
(b) Remuneration for the sale or licence of patents, trade marks, industrial models and designs and know-how, is subject to a 36% withholding (ITL, Art. 93(a)(2)); and
(c) When the agreements do not comply with the terms of the TTL, every payment will be subject to a 45% withholding on the gross (ITL, Art. 93(a)(3)).

The last paragraph of Art. 93(a) of the ITL states that when payments are made under an agreement which provides for obligations included in paragraphs 1 and 2 of the Article simultaneously, the higher rate, 36%, will be applicable to all the remuneration.

III. THE SOURCE OF THE INCOME

The basic principle of Argentine income tax law is that only income of Argentine source is taxed in Argentina (ITL, Art. 1).

Income is considered of Argentine source when it is originated in goods located or economically used in Argentina or in the performance in Argentina of any act or activity which produces the income (ITL, Art. 5).

However, a different principle governs fees and other remuneration originated in advice rendered from abroad. In effect, Art. 12 of the ITL provides that all fees and other remuneration from technical to financial or any other sort of advice rendered from abroad will be considered Argentine-source, regardless of the place where the service was in fact rendered.

As far as patents, trade marks, and know-how are concerned there are no inconveniences in determining the source of the income, because the patents, trade marks and know-how licensed to domestic companies usually will be economically used in Argentina and

1. France, Italy, Germany, Austria and Sweden, inter alia.

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consequently it is clear that royalties and other remuneration paid as valuable consideration for the use of such intangibles have an Argentine source, according to the general principle laid down by the law, and should be taxed in Argentina.

The question is, on the contrary, highly controversial in respect to technical assistance, engineering and consultancy services, where often the work is performed and the service rendered entirely outside Argentina, in the place of business of the person rendering the service, and consequently the source of the income would not be Argentina, would it not be for the application of Art. 12 of the ITL, which, as stated above, provides that all remuneration for "advice rendered from abroad" is of Argentine source.

Our courts have had the chance to hear several cases in which this matter was discussed.

In 1979 in re "S.A. Nestlé de Productos Alimenticios" the Federal Supreme Court held that "the word 'advice' used in Art. 12 of the ITL refers to every technical assistance excluding only the use of patents and trade marks which are compensated by the means of royalty payments". The Supreme Court held that "Art. 12 of the ITL refers to any sort of advice, of whatever nature, including a project for the building of premises and new installations, as well as the examination of product samples for quality control".

In a judgment dated 2 years later – 28 April 1981 – the Federal Court of Appeal in *Pasa Petroquímica Argentina S.A.* followed the principle laid down by the Supreme Court holding that "the term 'advice' should not be construed literally, but in the sense that it comprehends every payment abroad for technical assistance which is not made as consideration for the use of patents or trade marks, which are compensated by means of royalties".

The General Tax Bureau has ruled that "the instruction and preparation of personnel and cooperation and assistance of an administrative nature is technical assistance for the purpose of Art. 12 of the ITL" (Ruling 105/73 of 6 November 1973), but that "in order to determine the source of income originated in pre-feasibility studies contracted with companies domiciled abroad, the place where the work is in fact performed must be taken into consideration" (Ruling 43/85 of 10 December 1985).

The Federal Tax Court has ruled that "income originated in the preparation of technical documentation and of an operation manual necessary to build and operate an industrial plant, contracted with companies abroad, is not of Argentine source" (31 October 1975).

Based on the above-mentioned precedents it can be concluded that the courts have construed Art. 12 of the ITL very broadly determining that any remuneration paid for technical assistance from abroad of whatever nature is Argentine-sourced, but that, however, every particular case must be analyzed carefully to come to a conclusion on whether such income is subject to taxation in Argentina or not.

IV. TAXATION OF THE DIFFERENT INTANGIBLES

As explained above, the ITL taxes differently technical assistance, consultancy, and engineering services, on the one hand, and licences, sales of industrial rights, and know-how on the other.

(a) Technical assistance, engineering and consultancy

Income originated in the rendering of these services will be taxed at a 45% rate on 60% of the total compensation, that is to say, the effective rate wil be 27% on the gross, when the following requirements are met:

(i) the agreement has been registered at the INTI according to the terms of the TTL;
(ii) that such services are not obtainable in the country according to the opinion of the Application Authority in the TTL, that is to say, the INTI. Upon registration this authority has to issue a certificate stating whether the services to be performed are obtainable in the country or not. The Implementing Regulations of the ITL, Decree 2353 of 18 December 1986, establish that this requirement must be assessed by the Application Authority at the time when registration of the agreement is made (Art. 156); and
(iii) the services must have been effectively rendered by the time payment is made. As the Implementing Regulations clarify, this requirement refers to services which under the terms of the agreement should have been rendered by the time payment is due (Art. 157). The Implementing Regulations provide as well that if the services have not been effectively rendered upon closure of the fiscal year, the local company will not be able to deduct the payments for income tax purposes and such deduction shall be deferred until the time in which the services have been effectively rendered.

If these three requirements are not met, the 45% income tax rate will be applicable on the gross income.

(b) Patents, trade marks, industrial models and designs, and know-how

Income originated in the assignment of rights on or in the granting of exploitation licences of these intangibles will be subject to a 45% income tax rate on 80% of the gross, that is to say, an effective tax of 36% on the gross, as long as the agreements comply with the provisions of the TTL.

As in the case of technical assistance and consultancy services, if the agreements do not fulfil the requirements of the TTL, the 45% rate will be applicable on the gross – no deduction being allowed.

If the same agreement deals with payments subject to different tax rates according to the above explanation, all the payments will be subject to the higher rate. Accordingly, it will be necessary to execute two sepa-

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rate agreements to avoid the application of the higher rate.

V. DOUBLE TAXATION AGREEMENTS

As stated in Section I hereabove, Argentina has signed agreements to avoid double taxation in the field of income and capital with several countries. From these we shall refer briefly to the provisions concerning royalties and other remuneration of industrial rights, technical assistance, and consultancy services in the DTAs signed with France, Italy, Germany and Sweden, as these are the countries of business of most licensors of technology transferred to parties resident in Argentina.

(a) France

Art. 12 of the DTA states that taxation of royalties may not exceed 18% of the gross payment.

For the purposes of this article, "royalties" means all compensation paid for (i) the use of a patent, a trade mark or an industrial model or design, i.e. industrial rights, (ii) the use of a plan, a formula or a secret procedure, as well as of information regarding industrial, commercial or scientific experience, usually known as "know-how", and (iii) for scientific or technical studies or research work concerning methods or procedures of industrial, commercial or administrative nature, generally called "technical assistance" (which includes consultancy and engineering services).

The sole requirement for the application of the 18% rate limitation is that the agreements have been approved by the Application Authorities under the TTL.

(b) Italy

With a slightly different wording this DTA contains similar provisions to the one signed with France.

(c) Germany

The rate limitation is 15% of the gross compensation and it applies to remuneration paid for the use of the same intangibles as in the French agreement. As in the French and Italian agreements the sole requirement is that the transfer of technology agreements have been duly registered according to the TTL.

(d) Sweden

In this case the tax may not exceed 15% of the royalties' gross amount.

However, the term "royalty" is narrowly defined including payments for industrial rights and know-how: excluding those made for compensation of technical assistance and consultancy and engineering services. Accordingly, technical assistance and consultancy and engineering services under the terms of this DTA can be taxed in Argentina only if the Swedish company has a permanent establishment in Argentina.

No requirement exists in this case that the agreements comply with the TTL.

The question to answer is whether these DTAs have been modified by the 1985 amendment introduced in the ITL or whether the limited rates of 15% and 18% which they provide for and which are substantially lower than the ones applicable according to the ITL, continue in force, and whether the new requirements stated in the ITL for the application of the 27% and 36% rates are applicable or not (i.e. that services are not obtainable in the country in the opinion of the Application Authorities and that they are effectively rendered).

The Argentine Federal Constitution of 1853 does not have a provision which governs the relationship between treaties signed by the country with other nations and domestic laws. Article 31 of the Federal Constitution establishes that "this Constitution, the federal laws enacted by Congress and the treaties with foreign nations, are the supreme law of the Nation". However, this provision has been unanimously construed in the sense that it establishes the supremacy of federal legislation over local provincial legislation, but that it does not impose a determined rank between the Federal Constitution, the international treaties and the laws of the Federal Congress.

In other words, the Federal Constitution does not establish whether or not international treaties have a superior or an equal rank with other laws of Congress. In the first case a later law could not abrogate an earlier treaty, but in the case of equivalent rank, a later law could abrogate an earlier treaty.

The Federal Supreme Court of Argentina has twice held in clear terms that international treaties and federal laws have equal legislative rank and that the later law abrogates the earlier treaty (in re *Martín y Cía. Limitada v. General Management of Harrods*, 1963, and *Esso S.A. Petrolera Argentina v. Argentine Republic*, 1968).

A necessary consequence of this doctrine of the Supreme Court is that an international treaty is not by itself a special relationship which cannot be modified by a later law of general character under the interpretation rule according to which the later general law does not abrogate a former special law. In fact, in the "Esso" case the law which was attacked for being unconstitutional was a general law notwithstanding which the Supreme Court held that it modified an earlier treaty although this treaty could have been considered as regulating a special situation not affected by the later law of general nature.

Based on the foregoing it may be concluded that, according to the rulings of the Supreme Court, the DTAs signed with France, Italy, Germany and Sweden have been modified by the amendment in the income tax law introduced in 1985 and, consequently, the reduced tax rates provided for royalties in the DTAs are no longer applicable.

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However, in our opinion this conclusion is not correct. We believe that a DTA constitutes a special rule which governs the special and particular tax relationship with another nation and is not abrogated nor amended by a later law of general nature unless specifically provided therein. Law 23,260 is a law of general nature which does not contain any reference to DTA and, consequently, has not modified the DTAs.

This opinion is shared by several well-known constitutionalists in Argentina who have studied the matter carefully.

Based on the foregoing and on the fact that nearly 20 years have elapsed since the last ruling of the Supreme Court on this question, we are confident that the doctrine of the Supreme Court would be changed if the matter is once more discussed in the courts. The result would be that a general amendment of the ITL does not affect the DTAs that Argentina has executed with other nations, unless specifically provided for in the later law.

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Books

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To facilitate ordering, a list of addresses of the main publishing houses is included on pages 46-48 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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Monograph dealing with the various aspects, problems and phases in possible conflicts between the tax authorities and the taxpayer, including the execution of tax debt following court decisions.
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INTERNATIONAL CHAMBER OF COMMERCE

Symposium on Consequences for International Business of the U.S. Tax Reform

The paper presenting the major points of the U.S. Tax Reform Act of 1986 was delivered by Mr. Richard Hammer of Price Waterhouse. His paper, written in conjunction with Mr. William Rohrer, was published in the January 1987 issue of the *Bulletin for International Fiscal Documentation*. It is recommended that the reader be familiar with this article in order to fully benefit from the following 3 papers.

Impact on the Tax Policies of the United Kingdom

By G.D. Swaine

Since the Thatcher Government took office in 1979 it has been a policy aim to reduce the burden and rates of taxation in the United Kingdom. In fact the overall burden has if anything increased over the intervening years. But there has been significant progress towards reducing the rates of the direct taxes, most notably the reduction in the higher rates of tax on individuals in 1979, but coupled with a simultaneous increase in the VAT rate; and the reduction of the corporation tax rates in 1984, financed in part by a strong deceleration of fiscal depreciation. Most recently, in the 1987 Budget proposals announced last week the basic rate of income tax has been reduced to 27%.

The general thrust of past and continuing Government policy is unquestionably in line with much of the thrust of the 1986 U.S. reform, and indeed in some important respects has pointed the direction for the U.S. reform, at least for companies. Hence the U.S. reform is not likely to affect significantly the direction of further reform in the U.K., though it may influence the urgency with which reform will be pursued. The main purpose of this necessarily brief paper is therefore to try to reach some conclusions about how far the main components in the U.S. reform might serve as a pattern for further reform in the U.K., in particular to make further reductions in tax rates possible. A secondary purpose is to draw attention to some of the many U.S. changes in the foreign area, both for their relevance to the corresponding provisions in the U.K. from the tax reform standpoint; and because of the increased tax burden some of them may place on British and other foreign investors, and the doubts certain of them raise about how far foreign investors in the U.S. should confidently rely on continuing treaty protection.

A most important area I shall not deal with is the whole process of the U.S. tax reform and the degree of discussion and consultation over the two years and more it took to get the legislation through. Despite the very great constitutional differences which inevitably set the government processes of the two countries apart, the U.K. has a good deal it could learn from the U.S. in this respect.

STRUCTURAL ASPECTS – GENERAL

1. The first point to note is that the U.S. Tax Reform Act does not set out in any way to challenge or overturn the system and basis of the Internal Revenue Code by removing income, profit and gain as the tax base and putting something completely different in their place.

Quite the opposite. What it is, essentially, is an attempt to return to first principles *within an income-based approach to taxation*, but without changing the

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classical nature of the system by integrating the tax treatment of companies and shareholders (though that *was* an important part of the original reform scheme), without eliminating the separate taxation of capital gains, and without removing the credit method as the principal means for relieving foreign income from U.S. tax.

In other words the system and its form and structure haven't changed. It was never part of the plan to introduce a wholly new sort of system, based on concepts of consumption, dissaving, net distributions and so on instead of income; and the reform certainly isn't presented as a step towards such a system – though it *is* presented in terms of similar objectives – to simplify the Code, to make it more fair, and to promote better-based economic growth by removing specific tax incentives and establishing a more neutral system.

This is very important in relation to the possible direction of future reform in the United Kingdom, where many would-be reformers argue the merits of such innovative systems. They can hardly now ignore the fact that the United States, by far the biggest player on the international tax stage, has opted so emphatically, and so recently, to retain an income-based tax system.

Should we see that as effectively blocking, as a practical matter, the possibility of reform in the U.K. in the direction of an expenditure tax? Or instead as offering the clearest possible evidence of the inability of conventional income-based systems to deliver a satisfactory combination of simplicity and fiscal neutrality? Or both? Whatever the answers, the truth of the matter is probably that it makes the prospect of radical reform in that direction even less likely in the U.K. than it was previously.

2. The shape of the reform has been driven by three main forces, acting interdependently.

First, by the wish to make an immediate and drastic reduction in tax rates for individuals and companies, much more pronounced for individuals than has proved possible yet in the U.K.

Second, by a strong belief in the familiar arguments, supported by many in the U.K., in favour of fiscal neutrality but not a belief strong enough, ultimately, to sustain some of the more radical original Treasury proposals. For example to allow companies a 50% deduction for dividends paid; or to index capital gains, stocks, and the asset base for depreciation; or to index interest payments and receipts by taking the inflation element out of the tax deduction and out of the amount taxed.

Third, and overriding everything else, an insistence from the very beginning that the reform must be *revenue*-neutral; that taken as a whole it shouldn't cost the Treasury a single dollar of lost revenue. In the U.K. too this can be expected to remain an important consideration.

3. This all adds up to a reform in which sweeping reductions in the tax rates for both individuals and companies, but particularly for individuals, are balanced by means of large extensions of the tax base, again for both individuals and companies, but in this case particularly for companies, or those in certain business sectors.

The inevitable result is a staggering array of winners and losers, the main losers being the capital intensive industries.

CHANGES AFFECTING INDIVIDUALS

4. How far may we expect the changes affecting individual taxpayers – the reduction in the tax rates for individuals and the simplification of the rate structure – to influence further rate reduction in the U.K.?

Tax rates

5. The U.S. reform has swept away fifteen graduated brackets, beginning at 11% and rising to 50%, and replaced them with only two brackets: 15% and 28%. In other words, almost overnight, the *top rate* of tax for individuals in the U.S. will become approximately the same as the present *basic rate* in the U.K. (now 27%); and very much lower than the highest marginal rate (still 60%).

(This leaves out the additional 5% tax introduced by the Tax Reform Act to claw back the benefit of the 15% graduated rate *and* the personal exemptions between certain high income brackets and State income taxes.)

The differences go right down the income scale. For example, at any level of income within the U.K.'s basic 27% band the equivalent U.S. rate will be only 15%, or little over half, and it runs on at 15% through almost the whole of the U.K. 40% band as well. Quite clearly it's this area of the reform which presents the greatest challenge competitively for the U.K. Hence an important question is whether similar rate reductions could be partly paid for in the U.K. too by an extensive broadening of the tax base for individuals patterned on the U.S. model.

Base broadening

6. Unfortunately it doesn't take too long to realize that the two countries start from two quite different baselines.

Before the reform, the Internal Revenue Code offered individual taxpayers a wide range of tax shelters which the U.K. simply does not have. That becomes very clear from the large revenue savings the U.S. reform produces by cutting the shelters back, while leaving completely intact the hard core of mortgage interest relief, pension fund related "privileges" and so on, in other words the very areas where savings would have to be found in the U.K. to pay for meaningful reductions in the tax rate, unless the additional revenues were to be sought from further increases in indirect

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taxes or reductions in public expenditure. In the United States there was much more headroom, and it seems there still is even after the reform.

We can see this very clearly from the revenue-raising changes affecting interest deductibility, passive activity losses and the alternative minimum tax.

Interest deductibility

7. Before the reform U.S. taxpayers had a pretty free rein to deduct interest, whatever the form of credit or the purpose of the borrowing. For instance, all "consumer" interest – interest on personal loans and credit card debt to buy motor cars, and other consumer items for example – was fully deductible. This is in stark contrast to the U.K. where, since 1974, only mortgage interest (plus certain other items) has been deductible, and then limited to a single principal residence and the first £ 30,000 of borrowing.

Under the U.S. reform, the ability to phase out relief for consumer interest alone contributes nearly $ 30 billion of additional revenues over the period to 1990. But relief for "investment interest" – interest on debt incurred to finance portfolio investment for example – remains largely intact; and, following the reform, relief is still given for the full interest cost of buying and improving a principal residence, and a second home too, and of borrowing on the security of a property in order to pay "qualified" medical and educational expenses, within specified limits.

Hence, the ability to phase out consumer interest relief gave the U.S. a revenue-raising headroom not available for the U.K. since 1974 whilst at the same time retaining much more liberal relief for mortgage and other interest than in the U.K. even after the reform cutbacks.

"Passive activity" losses

8. An even bigger revenue-raiser from individuals – $ 36 billion to 1990 – is a series of provisions designed to stop losses arising on "passive" activities from being used to offset other income on a current basis, including portfolio income.

Again, there is no comparable scope for savings in the U.K.

Alternative minimum tax

9. The concept of an alternative minimum tax, which the Tax Reform Act extends beyond what existed previously, is not known in the U.K. system. Could it serve as a model?

The general idea is to establish an even broader tax base than for the normal tax, so as to ensure that individuals with current economic income pay at least a minimum amount of tax currently. Some items which can be expensed normally are capitalized. Asset depreciation is generally slower, and some income items which are normally exempt have to be included. Tax is then charged at a lower rate than the normal tax rate, 21% instead of 28%. If that calculation produces a higher figure than the normal tax, then the difference is paid as additional tax. The additional tax, or at least that part which relates to timing differences, is carried forward as a credit against future normal tax. It adds a dimension of complexity which is quite absent from the U.K. system, since it calls for two separate computations, one for the normal tax and another for the minimum tax. It also has its obvious dangers. It almost invites the total replacement of the normal tax by the minimum tax but at a rate higher than 21%, though there's no suggestion this is intended.

Further it could only be made really effective in the U.K. if it were used to disallow or cut back "core" reliefs such as mortgage interest and pension fund contributions which remain inviolate under the U.S. minimum tax in much the same way as they do for the normal tax.

For all these reasons an alternative minimum tax would be most unwelcome in the U.K. and it seems unlikely to be taken as a model in whatever base-broadening might take place as part of the price for further rate reduction.

Individuals – some concluding comments

10. Put very briefly, if, as must be the case, the drastic reductions in individual tax rates achieved by the U.S. make the case for low, or at least reduced, rates in the U.K. more compelling than was perceived previously, and perhaps irresistible, then the means at the disposal of the U.K. Exchequer are more limited than those which were and still remain available to the U.S. Treasury. Base-broadening would have to be taken much further; and coupled with revenue increases, or savings in public expenditure, outside the direct tax system.

This becomes even clearer if the revenue-raising changes in the corporate sector are taken into account, since those changes in net terms are the biggest single contributor ($ 120 billion over the period to 1990) to the reduction in tax rates for individuals.

CORPORATE CHANGES

11. Low corporate tax rates are already the mode in the United Kingdom and have been since 1984 as the result of changes whose basic elements set the pattern, in a very real sense, for the 1986 reform in the U.S.

Over the period to 1986 the rate of corporation tax on companies was reduced progressively from 52% to 35% (where it now stands) in a revenue-neutral exercise in which, in return, stock relief was abolished and the 100% first-year allowances for machinery and plant were progressively eliminated.

The U.S. reform follows a similar pattern, though more abruptly. The corporate income tax rate is re-

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duced from 46% to 34% (plus State taxes) and the investment tax credit, by far the most important capital investment incentive before the reform, is repealed. (In crude arithmetical terms almost the whole of the $ 120 billion transferred to the individual sector can be represented as deriving from this single change.)

There are in addition significant changes affecting specific industries adversely; very expensive (for companies) changes in the tax accounting rules designed to defer deductions and accelerate tax payment ($ 60 billion of additional revenues to 1990); and a new and broader alternative minimum tax ($ 22 billion).

12. Clearly, unlike many other countries, the U.K. should feel no need to reduce corporate tax rates still further in order to remain competitive, though of course the U.S. rate reduction reduces whatever competitive advantage the U.K. may have enjoyed since 1984.

In addition the U.K. has the advantage, in that context, of a partial imputation system to set against the classical system which the U.S. still retains despite the Treasury's (abortive) proposal to give a partial deduction for dividends paid. The relationship between the current corporation tax rate (35%) and the current basic income tax rate for individuals (27%), which provides the basis for the imputation rate, produces a very high rate of imputation. For individual shareholders this compensates, though not fully, for the marginal income tax rate advantage of U.S. shareholders following the U.S. reform. For exempt institutional shareholders receiving dividends from tax-paying U.K. companies it results in an integrated tax rate of some 11% only, calculated by reference to the pre-tax underlying profits; while for U.S. (or U.K.) institutions investing in U.S. companies there is no imputation. And of course in many U.K. treaties, most notably the U.S. treaty, a foreign shareholder is entitled to receive part of the imputation credit, thus reducing the integrated U.K. rate on the dividends and the underlying profits well below 35%, an important advantage in the competitive context unless negated by domestic tax in the shareholder's home country.

13. There is accordingly no reason to expect that the corporate tax reform in the U.S. will significantly affect tax policy in the U.K., except to make a future return to materially higher rates less likely (at least as long as the low rates are retained in the U.S.).

It seems unlikely too that any of the specific base-broadening changes will be taken as a model to be followed for significant change in the U.K., placing heavier burdens on the business sector.

Foreign tax provisions

14. The Tax Reform Act devotes over 80 pages to new provisions affecting both outward and inward investment:

- Stricter limitations on the foreign tax credit (1201-1205).
- Tightening of the source rules to transfer more income from foreign to U.S. source, and a parallel tightening of the rules for allocating interest, in order (1) to reduce the scope for using up excess foreign tax credits against low-taxed foreign income and (2) to tax a bigger share of international income, for example income from shipping and air transport (1211-1216).
- Various changes in the Subpart F rules for CFCs, to increase the income for direct attribution to U.S. parents (1221-1227).
- A number of provisions directly aimed at foreign taxpayers investing in the U.S., generally resulting in an increased burden on them to set against the benefit of the 34% tax rate, and in some cases raising new doubts about the reliability of protection under the U.S. tax treaties (1241-1249). The most important is the introduction of a branch profits remittance tax; the most newsworthy (at least in the U.K.) the elimination of double dipping for dual resident companies; and perhaps the most ominous, a new departure in the field of transfer pricing relating to "super" royalties, which raises some interesting questions about double taxation and possibly even about the future of the arm's length principle itself.
- Finally, a whole new set of rules intended to put the treatment of all foreign currency transactions onto a systematic and consistent basis. They cover the recognition of exchange gains and losses, the timing, and source determination. The general rule is to bring in *all* gains and losses – as realized and as income, in fact as interest received and paid. They also deal with the translation into U.S. dollars of income, losses, dividends and so on of foreign subsidiaries and branches (1261).

15. A number of common directional threads run through many of these changes: a deliberate increase in the burden on outward investment from the U.S., adding to the relative disadvantage for outward investment already implied in the reduction in the domestic tax rate; a deliberate increase too in the burden on certain foreign investors in the U.S., in some cases on a discriminatory basis, driven partly by the dictates of revenue-balancing and offering yet further clear evidence of a real lack of inclination in the U.S. Congress to see the United States' tax treaty obligations as having any overriding importance.

And in addition, like many other parts of the reform, far from simplifying the legislation as was said to be intended, the changes in the foreign area make it even more complex than it already was.

Are these models which should influence the tax policy of competitor nations or the global framework of international taxation? Most of US would believe not.

Foreign tax credit

16. It is of interest to compare the foreign tax credit rules in the U.S. after the reform with the U.K. credit

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system, particularly since the U.S. rules have often been held up as a model to show how narrow and uncompetitive the U.K. rules are.

Before the reform the U.S. rules were already immensely more complicated than those in the U.K., but at least they provided a systematic means of averaging high and low foreign taxes, first currently across income streams, though admittedly with some serious limitations, and then over time by carryback and carryforward of excess credits. There is no formal provision for this in the U.K. system, which limits credit on a strict individual source basis with no carryover.

Unfortunately, the reform brings the U.S. system much closer in terms of stricter limitation rules and at the same time makes it even more complicated than it was before, though still more liberal than the U.S. Treasury's stated ideal preference – a strict transactions approach – or their original proposal, which was basically a segregation of active and passive income on a country by country basis, coupled with some additional limitations. Congress considered that but rejected it and came down expressly in favour of averaging, but with much stricter limitations than before.

The reform keeps the "overall" or global limitation basis, but it's fragmented now by a whole new series of separate foreign income pots, or "baskets", each with its own separate, self-contained credit limit to stop excess credits spilling over from one class of income to another, for example, for:

- passive income (income such as dividends, interest and royalties, though not all dividends, interest and royalties)
- foreign oil and gas extraction income
- financial services income
- shipping income
- interest which has suffered foreign withholding tax at 5% or more on the gross amount
- and, in addition, separate limitation baskets, one for each company held, for dividends received from companies owned between 10% and 50%.

To add to the complication dividends from controlled foreign subsidiaries owned more than 50% are split between the baskets by looking through to the make-up of the underlying income in the subsidiary, right down the structure, tier by tier, however many tiers there might be; and there are elaborate rules for setting off losses and income between the various baskets, and for clawing back the benefit of any foreign-source losses set off against domestic-source income.

The new limitation rules are hardly a prescription for simplification and offer little as a model for others, including the U.K., to follow, though they still probably offer more flexibility than the U.K. arrangements in this area.

Branch profits tax (1241)

17. The branch profits tax is completely new for the U.S., though there was and still is a so-called second level withholding tax on dividends and interest paid by non-U.S. corporations, where 50% or more of the foreign corporations' gross income is effectively connected with a U.S. trade or business. The U.K. treaty prohibits the second level tax in most cases (Articles 10(5) and 11(6)), as it will the branch tax.

The branch tax was a Treasury proposal, not a Congress proposal, and perhaps that's important. Its whole purpose is to put U.S. branches of foreign companies on the same footing as U.S. subsidiaries of foreign companies. A wholly different solution would have been simply to eliminate dividend withholding taxes altogether; and indeed a reform which had taken the U.S. progressively in that direction, instead of retrogressively into a branch profits tax, would have been widely welcomed.

A branch will be taxed now first at the normal 34% rate on its profits and then at 30% or a treaty rate on deemed remittances. There's also to be a withholding tax on interest paid to non-residents by the branch, or by the foreign head office if the interest is allocable to the branch. The main potential effect is on banks, particularly those not resident in treaty countries, and real estate investments structured through U.S. branches.

The branch tax clearly breaches the treaty non-discrimination articles – for instance Article 24(2) of the U.K. treaty, which prohibits the U.S. from levying tax on a branch of a U.K. company less favourably than on a U.S. enterprise carrying on the same activities. But it's expressed not to override the treaties as a general rule. In other words it can't apply for example to U.K. banks under the present treaty, in normal cases.

However in treaty-shopping cases it will. Not only that, in treaty-shopping cases it will apply at the full 30% rate. That's done by unilaterally overriding the treaty meaning of residence, and putting a qualified definition in its place which excludes treaty shoppers. In other words, the branch tax establishes a statutory concept of residence and treaty shopping, which overrides all the treaties, including the U.K. treaty.

18. Though British banks will be protected by the present treaty it seems the U.S. Treasury intends to seek amendment of those treaties, again presumably including the U.K. treaty, which generally prohibit the branch tax. Without that of course the original aim of putting all branches on the same footing as subsidiaries would not be met. But it is hardly conceivable that the U.K. would concede amendment, placing additional burdens on U.K. investors in the U.S., while maintaining for U.S. investors in the U.K. the benefit of imputation tax credits through the treaty.

The logical thing then for the U.S. would seem to be to extend the "qualified residence" concept to subsidiaries as well as branches and get rid of the Article 16 problem by simply overriding the treaties again.

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Dual resident companies

19. The tax reform amendments to nullify the advantages from using DRCs will be echoed in the U.K. in corresponding measures in the 1987 Finance Bill and it is to be hoped that the consultations between the two countries will result in integrated treatment which will allow time for painless restructuring and guaranteed loss relief in one of the two jurisdictions.

"Super royalties"

20. Section 1231(e) amends Section 482 of the Code – the transfer pricing section – by adding these words:

"In the case of any transfer (or license) of intangible property . . . the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible."

What is meant by "commensurate with the income attributable to the intangible" is not known yet, but the clear intention, where royalties and other payments relating to intangible property are paid to a U.S. taxpayer by a related foreign party, is to allow larger adjustments to be made under Section 482 than the arm's length test would produce. This will be done by calculating the adjustment by reference to the amount of income the intangible is generating currently for the related party from year to year over the period of the agreement, and attributing part of it to the U.S. licensor. For example, if a foreign company manufactures a product under licence from a U.S. affiliate and makes profits the I.R.S. thinks are excessive in relation to the licence fee, part of the profits will be attributed to the U.S. affiliate under Section 482, with the benefit of hindsight, even if the licence agreement was entered into on fully arm's length terms.

This looks very much like a rejection of the arm's length principle in a very important area, or at least an acknowledgement of its inadequacies and a wink in the direction of unitary taxation; and it's not at all clear where that might lead eventually. Whether the new rule will be defeated in treaty cases by the associated enterprises articles isn't clear either. It clearly conflicts with them. But it doesn't seem to be expressed not to override the treaties, in which case it may well prevail over pre-existing treaties and lead unavoidably to double taxation.

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21. There are other provisions in the Act of concern to those in the U.K. who invest in or trade with the U.S. Of more general and serious concern were certain of the failed proposals which, like FIRPTA in 1980 and the branch tax in 1986, provide further clear evidence of a disturbing disinclination in the Congress to respect the treaty obligations of the United States, the most serious example being the outrageous "earnings stripping" proposal which fortunately was defeated this time but cannot be guaranteed not to be revived.

Impact on the German Tax System

By Dr. K.D. Wingert

The three objectives that President Reagan sought to achieve when undertaking his tax reform are of equally great importance for German taxation policy, namely the three goals of fairness, simplification and growth. While these three goals were no longer mentioned in the final official title of the American law, from the German point of view the degree to which they have been achieved by the American tax reform varies considerably.

The goal of fairness can be seen above all in two ways:

(a) an increased burden of taxation on the higher tax brackets, particularly as a result of abolishing the so-called tax shelters, with corresponding tax relief for those on lower incomes;
(b) a reduction in taxation on private incomes by an estimated 120 billion U.S. dollars spread over five years, to be financed by correspondingly heavier corporate taxation.

The second goal, that of simplification, does not seem to have been realized. Both the actual extent of the law, with its numerous transitional provisions, and also the fact that many of the detailed provisions will have to be formulated as regulations within the next few years, all this indicates that American tax law is, in fact, more likely to become even more complicated. It is probably true to say that the Reagan tax reform is yet another proof of the old rule that in a highly differentiated society, a simple tax law is bound to remain an illusion. In the Federal Republic of Germany, the goal of simplification has also long been an integral part of every significant alteration in tax laws which aspires to be a tax reform. But in Germany, too, it must be doubted whether any major simplifications can be brought about within the foreseeable future.

The aim of growth as the third objective of the U.S. tax reform was intended to be achieved by the tax relief on private incomes stimulating consumption, and, above all, by removing the tax shelters so that private investment would no longer be guided by the desire to reduce tax burdens, but by the consideration of productive yield. This second factor, the abolition of tax advantages for private incomes, can no longer play a significant part in the Federal Republic of Germany, since the opportunities that used to exist for

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high tax savings through depreciation, while committing relatively low amounts of capital, have been considerably restricted in recent years.

The first aspect, that of stimulating consumption by granting tax relief, is one that has been gaining ground, particularly in the last few weeks of the political debate, because the very latest indicators of economic growth are well below the figures of previous years. For this reason, in particular, it was decided at the beginning of March 1987 to implement the tax cuts planned for 1988 on a larger scale than had been originally envisaged.

The U.S. tax reform coincided with a very special situation in the Federal Republic of Germany. As you are aware, on 25 January 1987 the Federal elections for the German Bundestag were held. The election of the Bundestag, the lower house of the German Parliament, decides which parties will provide the Federal Chancellor and make up the Federal Government. It is thus the most important election for determining the future political course to be followed during the lifetime of the next Parliament.

As you will also know, the conservative parties, the CDU/CSU, won the election, but rather less clearly than previously expected. In contrast, the liberal FDP party, which has been the junior partner in the coalition with the CDU/CSU for the previous four years, managed a sizeable increase in its share of the poll. On the other side of the spectrum, the socialists (SPD), as the main opposition party, were unable to make any headway. So as a result of the elections, the existing coalition of conservatives and liberals under Chancellor Kohl will continue in office.

The U.S. tax reform, coming in the autumn of 1986, thus coincided with the beginnings of the campaign for the Federal elections on 25 January 1987. The U.S. reform played some part in German electioneering, because tax policy turned into a very big issue in the campaign. And it has continued to be one of the central factors in the negotiations held in February and March prior to the forming of a new coalition government. Rates of taxation proved to be highly contentious during these negotiations.

The U.S. tax reform made its presence felt during the election campaign and the negotiations over the forming of the new government, and will also have an impact on future discussions and policy decisions on taxation in the Federal Republic of Germany. The U.S. reform has a particular influence as a result of what can be considered its distinctive feature: a massive reduction in rates of tax, together with the abolition of exemptions from tax. The top rate of tax in Germany is 56%, but in the field of corporate taxation this has to be taken in conjunction with additional burdens from local business tax on income and net worth, so that the total tax burden can amount to 70% of profits. Seen in this light, tax rates of 34% and 28% appear as practically inconceivable.

People of all political persuasions in the Federal Republic of Germany have been in agreement for years that the burden of taxation must be reduced. What is controversial is the timing of tax cuts and, in particular, the question of to what extent corporate taxation should be cut. The opposition parties, above all, who propose only minor corporate taxation relief, or even reject any reduction whatsoever, have looked to the U.S. tax reform for support for their arguments. They wish to emulate the example of the U.S.A. with its shift of $ 120 billion of tax burdens to industry, spread over a period of five years. The German opposition parties have consequently drawn the conclusion from the U.S. tax reform that the proposed tax cuts in Germany should also be financed by increasing the burden on industry. However, a closer analysis of the changes in the U.S. tax law indicates that it would simply not be feasible for the Federal Republic to attempt to adopt the same course.

The impossibility of Germany adopting the present changes in U.S. corporate taxation can above all be seen from the apparent paradox in the changes in tax law in the U.S.A. At first sight it would appear to be completely incomprehensible that a massive cut in tax rates – with corporation tax being reduced by more than a quarter, from 46% to 34% – will actually lead to an appreciable increase in corporate tax burdens.

The apparent contradiction is quite easily resolved: the reduction in tax rates has gone hand in hand with a widening of the basis for tax assessment and with a large-scale reduction in tax concessions. The increase in revenue from corporate taxation in the U.S.A. after the tax reform is primarily achieved by tightening up the regulations for determining the taxable income to which the tax rate applies.

This can most clearly be seen in the abolition of the Investment Tax Credit and in the limits imposed on depreciation allowances under the Accelerated Cost Recovery System (ACRS). The suspension of the Investment Tax Credit will be by far the largest item in extra-corporate taxation. In the past, the combination of Investment Tax Credit and ACRS led in individual cases to tax savings that even amounted to more than an immediate 100% depreciation allowance. These and other tax concessions meant that in the past companies in the U.S.A. were charged relatively low levels of tax, and in certain cases no tax was due at all, in spite of a "normal" level of profits.

Since corporate taxation law in the Federal Republic of Germany does not contain any such favourable provisions in the first place, there can be naturally no question of imposing similar restrictions on such concessions. Even after the latest tax reform, the tax provisions in the U.S.A. are generally still far more favourable than in the Federal Republic of Germany. What is more, German companies also have to shoulder the burden of taxes that are imposed independently of profits, such as wealth tax and business tax on net worth.

During the negotiations over the policies to be pursued by the newly elected coalition government over the next four years, the argument that tax relief for private

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incomes should be financed by heavier corporate taxation was simply not an issue. This is hardly surprising, since for the ruling coalition parties tax relief for industry has always been one of the central goals of the next tax reform. As a result, there is inevitably a decisive difference between German tax policy and the 1986 U.S. tax reform.

If both private incomes and also industry are going to be granted some tax relief, then this tax reform cannot be self-financing. The internal balance of the Reagan tax reform, its neutrality with respect to the size of revenue, is one of its major components, and one that was dictated by the huge budget deficits in the U.S.A. Tax relief for private incomes, particularly for the lower income brackets, could not be allowed to lead to lower tax revenues. It therefore had to be paid for by increased burdens in other areas.

In contrast to the U.S.A., the tax reform in the Federal Republic of Germany, which has been under discussion for years, is intended to lead to a drop in the tax ratio, i.e. the state is to collect less tax as a whole. Thus the German tax reform is planned from the outset not to be neutral with regard to revenue. That this should be at all possible is due to the fairly consistent policy of economy measures pursued by the last Federal Government. This policy is primarily associated with the name of the Finance Minister, Stoltenberg.

The decisions on tax policy over the next four years which have now emerged from the negotiations over the formation of the coalition government envisage planned gross tax cuts of around 45 billion DM a year. About 50% of this is to be met by increases in taxes elsewhere, for example by cutting tax concessions and subsidies, and by raising transfer and excise taxes. This means that about 50%, or 20 to 25 billion DM, is left over as net tax relief. It can thus be clearly seen that the central measure of the U.S. tax reform, namely cutting rates of tax in exchange for the abolition of tax exemptions, will also be the main mechanism employed in order to introduce tax relief under the policy planned in the Federal Republic of Germany.

A reduction in rates of tax is also in the forefront of the government's mind in its decisions on taxation. Thus the rate of corporation tax for non-distributed profits is to be cut from 56% to 50%. This reduction by 6 percentage points means a cut of 10.8% in the burden on retained profits. The tax on distributed profits remains unchanged at 36%.

What is of greater importance is the tax scales which apply to private incomes and to companies with the legal form of a partnership. Unlike the U.S.A., the Federal Republic of Germany has a progressive tariff in this field. You can see from the diagram before you that the 1981 tax scale in force to date begins with a lower proportional zone of 22%, and then rises in a curve to the upper proportional zone, where the top rate of 56% is levied.

The curve below traces the tax scale which is to come into effect from 1988 onwards; here the progression rises much less steeply, particularly in the middle income brackets.

The new scale planned for 1990 onwards contains a linear progression between the lower and the upper proportional zone, thus between the basic and the top rate of tax. The basic rate is to be reduced from 22% to 19%, and the top rate from 56% to 53%. However, the top rate of tax will now also be levied at incomes lower down the scale, 120 thousand DM for single persons and 240 thousand for married couples, instead of the present 130 thousand and 260 thousand respectively.

The lower proportional zone is to be shortened so that from 1990 the progression will begin at 8,100 and 16,200 DM respectively. This will entail loss of revenue of 6.7 billion DM. In addition, the tax-free basic allowances are to be raised by 1,080 and 2,160 DM to 5,616 and 11,232 DM respectively. Since these increased allowances will benefit all taxpayers, they will also have a major effect on tax revenues. Moreover, there will also be increases in a variety of tax concessions granted to families.

With regard to corporate taxation, there will be an improvement in the special depreciation allowance for smaller companies under § 7(g) of the Income Tax Law. This means that the sole measure so far agreed that will provide tax relief for all companies is the reduction of the top rates of income tax and of corporation tax. Whereas these rates were previously fixed at the same level of 56%, they will now diverge, with 53% as the top rate of income tax and 50% as the standard rate of corporation tax for non-distributed profits. Since many companies in the Federal Republic of Germany, even including multinational enterprises in some cases, are organized in the legal form of a partnership this divergence in the tax rates for income tax and corporation tax will operate to the disadvantage of partnerships. The argument that income tax contains lower tax rates than 53% for the first parts of incomes, while corporation tax of 50% will apply equally to all non-distributed profits, is not convincing because the top rate of income tax will already start to apply to an income of 120,000 or 240,000 DM. The proposed changes are therefore a clear contravention of taxation neutrality with regard to the legal form of enterprises.

The planned German tax reform so far does not envisage any changes in business tax on income and net worth. Since these tax forms are particularly onerous in loss situations, they represent serious obstacles to new investment, in which there is regularly a high level of business risk involved. Such corporate taxes as these are unknown in other industrialized nations. So they are an additional factor in putting German firms at a disadvantage in competing with companies from other countries.

The proposed cut in German tax rates to 53 and 50% can only be described as timid in comparison with the radical reduction in the U.S.A. This casts doubt on whether German industry will be able to cope with the competitive advantage American enterprises thereby

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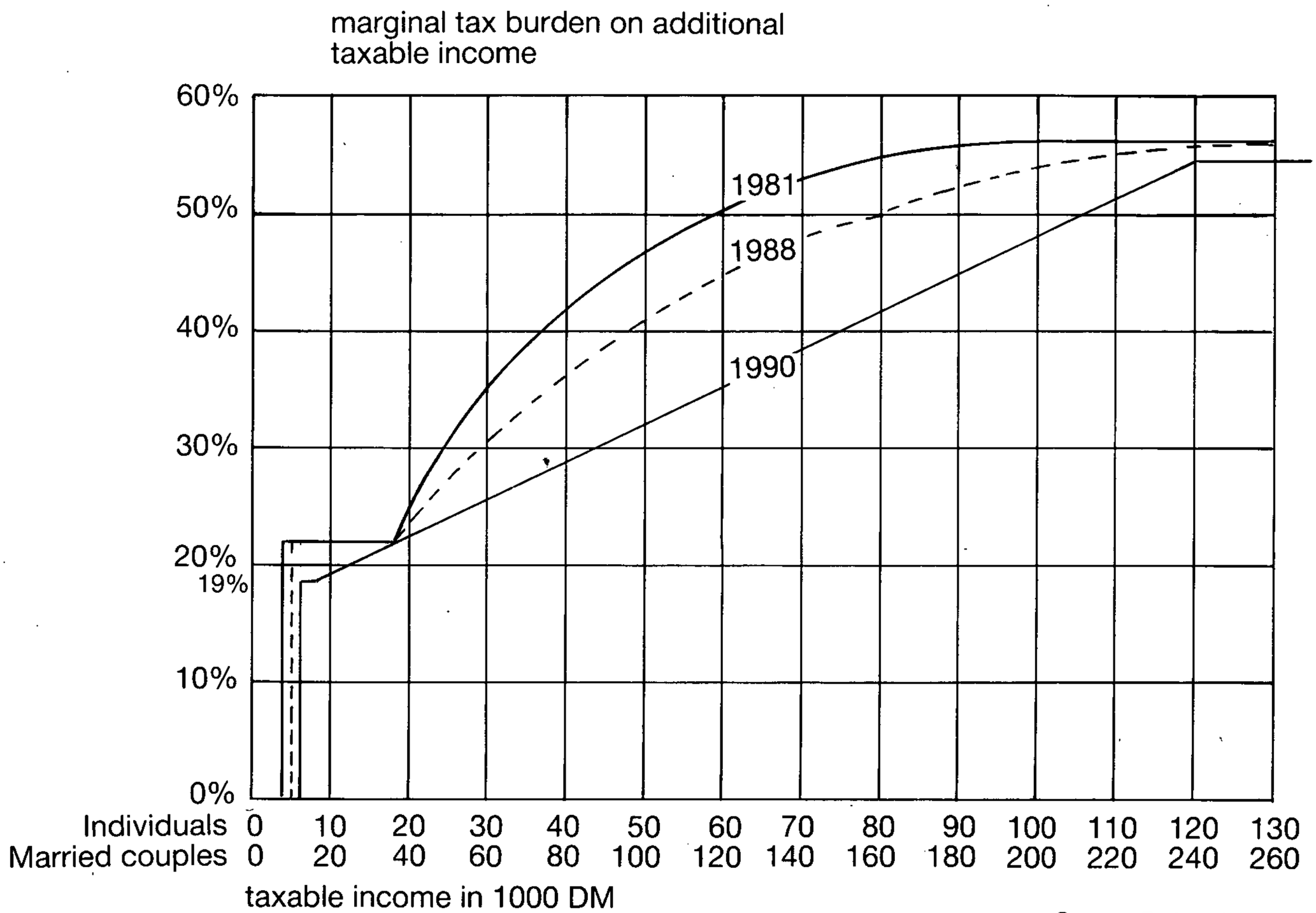
enjoy. The question arises whether the Federal Republic of Germany can continue to be an attractive country for investment. There is the danger that, in view of the continuing extremely high tax burden on investment in the Federal Republic, U.S. companies, and probably firms from other countries as well, will hold back, and that German firms will be increasingly compelled to consider investing abroad, rather than at home. To sum up, while the proposed German tax reform does make an attempt to emulate the U.S. tax reform in cutting tax rates, it must be said that this attempt falls short of the mark.



Source: Federal Ministry of Finance.

Impact on the Japanese Tax System

By Shigeru Nomura

Mr. Nomura is a partner in the firm Ernst and Whinney.

I am very pleased to have a chance to explain the Japanese tax system and the impact of the U.S. Tax Reform Act on Japanese taxation. Today I would like to explain the relation between Japanese companies' behaviour and the tax system from an historical viewpoint.

The Japanese tax system after World War II had considerable influence from the tax system of the United States in the early period. Based on the recommendations of Professor Carl Shoup of the U.S.A. for an overall tax review, a major tax reform was carried out in 1950 which was oriented toward placing direct taxes, especially income tax and corporate tax, as the mainstay of the whole tax system. In subsequent years, while minor revisions have been made in an effort to adjust the tax system to the economic and social environment, an overall review has never been made. With the progress of the Japanese economy and changing social structure, however, inequity and imbalance in the present tax system have become more apparent, and a necessity for comprehensive reforms to the current tax system has been voiced strongly by the Government's tax system study council, especially in the past two years. Thus, the developments of the U.S. tax reform have been watched with great concern and are considered to have had much bearing on the proposed 1987 tax reform bills, which the Government presented to the Diet in late January.

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Especially, the reduction of income tax brackets and lowering of individual tax rates and the lowering of corporate tax seem to have had a positive impact on the proposed reforms. The proposed reforms, similar to the U.S. tax reform, aim at fairness, simplicity and growth. They are designed to broaden the tax base by introduction of a new indirect tax – VAT, lower tax rates on individual and corporate income taxes and reduce the Government's reliance on revenues from corporate and individual income taxes.

Now let's consider the historical aspect of the Japanese tax system. Japan is a small country with 370,000 km^2 which is smaller than the State of California; however, the population is about 120 million which is almost half that of the U.S.A. Additionally, 87% of the land is covered by mountains, and mineral resources and foods are not enough even for domestic consumption. To import mineral resources and foods from foreign countries, Japan needed foreign currencies. To get the foreign currencies, Japan has to import raw material, and export industrial products like textiles, steel, automobiles, electronic appliances and so on.

The main exported products have been changed from labour-intensive type products like textiles to capital-intensive products like steel and finally to high-technological products because of competition with other countries in terms of labour and capital cost.

Nowadays several products made in Japan are very competitive throughout the world and even create several problems in some countries. Large Japanese companies have been listed in the Fortune 500.

There are several reasons why Japanese industries could grow to the present position from almost nothing just after World War II. Many books introduced Japanese management style, diligence of workers, quick commercialization of good ideas developed by foreign researchers, etc., as secrets of success.

I would like to emphasize that the assistance of the Japanese Government as "President of the Japanese Corporation" had strong effects on Japanese industries.

In the past, the corporate tax rate in Japan was almost comparable with those of other major countries. However, the Japanese Government gave several tax benefits to enterprises to strengthen their financial basis.

A typical example of the governmental assistance is Special Tax Incentives (SOZEI TOKUBETSU SOCHI-HOU). Main items of the incentives are as follows:

- Special tax credit for R & D costs.
  If the amount of R & D cost of the year is the highest one since 1967, 20% of the difference between R & D cost of this year and the second highest one can be credited against income tax.
- Special depreciation on machinery for energy saving, anti-pollution, excess usage etc.
- Inventory price fluctuation reserve.
  A company could provide reserve for valuation loss on declining inventory price as a tax deductible expense.
- Reserve for loss on foreign investment as a tax deductible expense.
- Reserve for overseas market exploitation as a tax deductible expense.

Japanese companies could accumulate the funds from the above assistance and invest it in the newest production line to manufacture better products at lower costs. Then, they could develop foreign markets to sell the above products and to obtain money for re-investment purposes.

As a result of this kind of Japanese company behaviour, we can see a lot of Japanese products at relatively low prices throughout the world.

A negative result has been that industries in other countries have been damaged by Japanese products, and the economies of major countries have fallen into stagflation. Each Government has tried to stimulate its economy in several ways, including changes of tax laws.

The Tax Reform Act presented by the U.S. Government had a major effect on the tax laws of the other countries. As I mentioned previously, Japan has also been affected. The U.S.A., U.K., France and some other countries lowered their corporate tax rate, consequently, Japanese industries requested their Government to lower the tax rate which had become higher in relation to other major countries. If all infrastructures except for the effective tax rate of major countries are the same, big enterprises might shift their operations and investments to the country having the lowest tax. Therefore, the Japanese Government has to respond somehow to requests from industries. On the proposed 1987 tax reform bills, the Government allows for lower corporate income tax and individual income tax; however, a new value added tax system is introduced to compensate for the tax cut on corporate and individual income tax.

The new Japanese VAT system is almost comparable with EC-type VAT. The proposed tax rate is 5% and this tax will bring 4,500 billion yen (US$ 30 billion) for the first year 1988. VAT will be imposed at each stage of sales from manufacturing to retailing and enterprises can claim refund of VAT paid for creating new value. Businesses with annual sales of less than 100 million yen will be exempt from the tax; however, they have no right to claim a refund of VAT charged at the previous stage. Certain categories of goods and services, including foodstuffs, education and medical will be exempt from the tax. Theoretically, the new VAT

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should be neutral, with no effect on profit and loss at the corporate level. However, some economists anticipate that companies cannot charge 5% VAT on their invoices, and approximately 50% of the VAT amount will be borne by the companies at the consumer level. Also, VAT will raise the price index and decrease demand. This means the new VAT system will have negative impacts on the enterprises. Many companies will seek the chance for export sales, which are tax-free and thus avoid the negative effects of VAT.

There are big debates about implementation of VAT. Opposing political parties and retailers' unions have big campaigns to ruin the tax bill. Once the Government succeeds in implementing the VAT law, the Japanese tax system can be changed from a direct tax style to a multiple source style.

The Government might rely heavily on income from VAT in the future as the other governments do. If other countries lower corporate tax rates, the Japanese Government will respond to requests from industries by raising the VAT rate.

If the 1987 tax reform bill is approved by the Diet, the following are major revisions:

- The present corporate income tax rate of 43.3% will be lowered to 37.5% in three years.
- The lower tax rate applicable to dividend payments will be abolished.
- The effective corporate tax rate (including inhabitant and enterprise taxes) will be lowered to below 50% from the present 52.92%.

The following table is a summary of the above relations:

	Present	1987	1988	1989
Corporate tax	43.3	42	40	37.5
Lower tax rate applicable to dividend	33.3	34	35	—
Dividend ratio over taxable income				
0%	56.06	54.70	52.60	49.99
30	52.92	52.19	51.03	49.99
50	50.82	50.51	49.99	49.99
100	45.59	46.32	47.37	49.99

The rate of exclusion from income of dividends received will be lowered to 80% in three years.

The other major items are as follows:

Individual income tax

- The income tax brackets will be reduced to six from the present fifteen in two years.
- The maximum income tax rate will be lowered to 50% from the current 70% and the minimum rate to 10% from 10.5% in two years.
- A special deduction of 150,000 yen will be allowed for spouses of taxpayers with an aggregate income of less than 8 million yen.
- Salary earners will be allowed to deduct expenses.
- Individual inhabitant tax brackets will be reduced to four from the present fourteen brackets and the maximum rate will be lowered to 15% from 18%.

I wished to cover the major points of these subjects, and hope my speech is useful for you in understanding the Japanese tax system and Japanese companies' behaviour.

DRAFT CONCLUSIONS

The distinctive features of the U.S. tax reform consist of a significant reduction in tax rates – which makes U.S. corporation tax rates among the lowest in the world – coupled with an across-the-board elimination of investment tax credits and tightening of corporate deduction. But, although it lowers the corporate tax rate from 46% to 34%, the reform will involve an expected shift of a $ 120 billion tax burden from individuals to industry in the next five years, as a result of the limitation of these tax benefits. The reform can therefore be expected to have a significant impact on international business and investment practices and strategies for the future, both in terms of the activities of U.S. businessmen abroad and non-U.S. investors in the U.S.

The effects of the reform will be felt by international business in a number of ways, among which are those concerning the branch tax and the foreign tax credit.

The branch level tax is the wrong approach: it is detrimental to international trade and investment. It could require a total re-evaluation of doing business in the U.S. for non-U.S. enterprises although this would be precluded by most tax treaties. Many complexities and unanswered questions remain with respect to the addition of this provision to the U.S. Code. The foreign tax credit provisions have been made more restrictive and complicated beyond any necessity. But, as fiscal considerations are not the only ones to be taken into account, some high-tax countries will remain attractive if they provide good business opportunities, and it is expected that U.S. investors will manoeuvre within the new rules rather than pull out of high-tax countries.

The changes in the U.S. law, in particular the lowering of the corporation tax rates, have watered debate over tax reform in other countries. How other countries will react will nevertheless depend to a large extent on the present context of their own taxation systems and economic concerns. In Germany, for example, the corporate tax rate is among the highest; in addition a burdensome business tax on income and net worth is a levy that does not exist at least to such an extent in other countries. Business and industry circles have

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long been outspoken in trying to convince the government of the need to lower the trade and business wealth taxes as well as the corporation tax through a reform of the whole system. But now it is envisaged to concentrate the reform on taxation of individuals, keeping in mind that 90% of German enterprises are carried on by individuals and not by corporations, so for corporations only, the corporation tax rate for non-distributed profits will drop from 56% to 50%, limiting the share of the total gross amount of the tax reduction of 44 billion marks to only about 1.7 billion for corporations. In addition business and industry circles fear that net amount of the proposed reduction will still even be negative and therefore inadequate for efficient competition in the international market.

Japanese taxation law contains significant incentives for business. In light of the lowering of corporate taxation rates in several countries, including the U.S., the United Kingdom and France, Japanese industries requested a reduction in corporate tax rates. They are contained in a reform bill which was presented to the Diet in January 1987, but are accompanied by other provisions intended to broaden the tax base. Such provisions include in particular the creation of a VAT system comparable to that existing in Europe. As it is considered that the VAT will raise the price index and decrease demand, business and industry anticipate a negative impact on enterprises, which must turn to export sales to avoid VAT imposition.

The U.S. tax reform is expected to have a substantial impact on investment strategies. As far as investment by non-U.S. enterprises is concerned, the following changes are anticipated: 1) fewer U.S. branches of non-U.S. corporations; 2) fewer investments in partnerships; 3) more physical persons – as opposed to corporate entities – investing in the U.S. by means of partnerships; and 4) more direct investment, as opposed to participation in holding companies obtaining less than 80% of the amount of distributed dividends. But many questions and open issues remain to be resolved in the future, probably by regulation, before the best strategies will emerge.

The ICC hopes that this symposium has responded to the need of international business and legal circles to be informed of some far-reaching effects which have already begun as a result of the U.S. tax reform. The international business community is concerned about tendencies toward promoting isolationism and protectionism in tax relationships among the world's trading partners. The ICC will continue to make every effort to act as a leader in responding to the concerns of the international business community and in providing the services which may be are necessary to stimulate fair and free competition world-wide. The ICC would very much welcome hearing from you about any business issues or problems you are confronted with.

In next issues:

Liechtenstein: Tax Reform
by *Dr. N. Seeger*

German Democratic Republic: The Structure of Obligatory Payments to the National Budget and the Management of the Socialist Economy
by *Erhardt Knauthe and Hans Spiller*

Joint Ventures between East and West
by *Prof. Dr. Dennis Campbell*

Romania: Taxation of Joint Ventures and Non-residents
by *Ioan Condor*

Belgium: Coordination Centres
by *Jean-Pierre Lagae*

Belgium: Simulation, Fraus Legis and Business Purpose
by *J. Malherbe*

India: Tax Treatment of Payments under Foreign Collaboration Agreements
by *Har Govind*

Planning for Belgium Coordination Centres after the U.S. Tax Reform
by *Charles Sibille and Michael D. Fryt*

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UNITED KINGDOM:

Living with Anti-Tax Haven Legislation: Three Years of U.K. Experience

By A.D. Ross

In July 1984 the U.K. became the sixth country to enact legislation specifically designed to counter the avoidance or deferment of tax in the home country through the use of tax havens. A summary of the statutory provisions is to be found in Appendix I.

COMPARATIVE SURVEY

The U.K. legislation, known as the Controlled Foreign Companies or CFC legislation, contains many of the features common to all the systems which have preceded it – those of the U.S., Canada, Germany, France and Japan – while including some that are unique. There is less emphasis on the distinction between "passive" and "active" or "tainted" and "untainted" income, so that unlike the U.S. and Canadian systems there is no attempt to sweep into the net all income of an unacceptable type irrespective of where it is earned.

The legislation attempts to define "tax haven" by providing that a foreign company is caught by the legislation if the actual tax paid by it in its country of residence is less than one half of the U.K. tax that would be payable if the company were resident and fully taxable in the U.K. Clearly such a definition may embrace territories other than those traditionally regarded as tax havens, and the statutory provision is accordingly modified by the existence of a non-statutory list of countries published by the Inland Revenue. Unlike those of Japan, Germany and France, the list does not contain the names of tax havens, but in order to avoid ruffled feelings in territories which might resent being blacklisted in this way, it lists instead those territories – referred to as "Excluded Countries" – to which the legislation will *not* apply. Full details of the List are set out in Appendix II.

Common features

There are two basic similarities to be found in the legislation of all six countries: in each case the legislation is aimed primarily, but not exclusively, at tax haven operations, and in each case it is possible for a controlled foreign company (CFC) to be exempt from the legislation where it carries on in its country of residence a genuine commercial operation, maintaining premises and staff in that country, and dealing at arm's length with unconnected parties, even though little or no tax may be levied on the profits from its activities.

The U.K. legislation specifically provides for this type of company, described as "engaged in exempt activities", and the detailed rules are modelled on those of Japan.

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He is a member of the London Chamber of Commerce Taxation Committee, a member of the Advisory Board of the American Tax Institute in Europe, and a member of the International Fiscal Association.

He writes and lectures extensively: recent publications include "Employment Abroad – A Guide to the Tax Problems" and "Controlled Foreign Companies – A Guide to U.K. Tax Law and Practice", both published by the Institute of Chartered Accountants in England and Wales.

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Limitations in scope

The U.K. legislation is not as wide in scope as that of some other countries. For example:

(i) The capital gains of a CFC are not included in taxable profits and consequently are not subject to U.K. tax.

(ii) The legislation applies only to corporate shareholders, and not to individuals. There has long been a provision in our tax law – dating back to 1936 – which has a similar effect for U.K. resident individuals. Now Section 478 of the Taxes Act, it imposes U.K. tax on a foreign company's unremitted profits which arise as a result of a "transfer of assets" (widely defined) and which a U.K. resident individual has "power to enjoy".

Other features of the U.K. system

Only profits of a foreign company "controlled" by U.K. residents are caught by the legislation. If more than 50% of the voting power is in the hands of U.K. residents (who may include individuals and need not be connected) the company will be U.K.-controlled for this purpose.

Tax is not charged on a U.K. company if the amount of profits apportioned to it, plus the amount apportioned to any other person (company or individual) connected with it, is less than 10% of the total profits.

TESTS FOR EXCLUSION

Apart from the List of Excluded Countries, the legislation provides a number of "escape routes" or tests for exclusion from the effect of the legislation, so long as the prescribed conditions are satisfied.

Details of these tests are set out in Appendix I. The more important of them are now discussed:

The acceptable distribution test

A U.K. shareholder will not be taxed on the CFC's profits if that company has within 18 months of the end of its accounting period distributed a dividend out of those profits to U.K. resident shareholders. The proportion of the profits attributable to U.K. shareholders that must be so distributed is 50% if the CFC is a trading company, 90% if it is not.

"Available profits"

As originally drafted, the legislation provided that the distribution was to have been the appropriate percentage of the profits as computed for U.K. tax purposes. In view of widespread protests that followed, on the ground that a company might be required to distribute more profit than it had actually received, the definition of profits was amended to follow the rule established in case law many years ago for the purpose of double taxation relief: "profits" are the profits available for distribution as shown by the accounts of the company paying the dividends. The rule is modified to exclude capital profits and losses (as defined).

There is a planning point here since "profits" will be those shown by the accounts drawn up in accordance with local (e.g. tax haven) law and practice, and it is easy to envisage situations where such profits could be substantially less than profits as computed for U.K. tax. For example, a foreign company lends interest-free to associates, and has no interest income for accounts purposes, but for tax purposes a notional interest income would be imputed. Similarly, the profit could be depleted by reserves or provisions acceptable under local law and practice, but not deductible for U.K. tax purposes.

Points of contention

There are two other areas of doubtful interpretation which U.K. groups have sought to use to their advantage:

(i) A group decides to discontinue the operation of a CFC with a large undistributed surplus. The U.K. parent would be taxable on receipt of this surplus, whether in the form of a dividend or distribution in liquidation. A common solution is to make the company tax resident in the U.K., so that the surplus can be distributed tax-free to the parent company.

Some groups have then taken the further step of maintaining that such a dividend could satisfy the acceptable distribution test in respect of profits arising while the company was a CFC, prior to the date it was made U.K. resident, in an attempt to avoid U.K. tax on both the profit and the distribution.

The Revenue have strenuously resisted this device, and the 1987 Finance Bill contains an amendment to make such a claim impossible in the future. This is the first and so far the only change in the legislation since it was first enacted.

(ii) An acceptable distribution must be made within 18 months of the end of the CFC's accounting period. The legislation provides for the dividend to be passed through an intermediate foreign company, but does not specify that the dividend from the intermediate company must itself be received within the original 18-month period.

The Revenue maintain that it is implied in the law that this must be so. The point is at least arguable.

Meeting the acceptable distribution test is the most popular and effective means of continuing to live with the CFC legislation. The Revenue are well aware of the weaknesses in the provisions, and further changes in this part of the legislation may well come in due course.

Exempt activities test

This is the test already referred to, which, if satisfied, allows the CFC to carry on a genuine commercial

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activity with non-connected parties. No U.K. tax is payable, even if no foreign tax is payable by the CFC.

Certain activities cannot qualify: holding of securities, patents or copyrights, dealing in securities (other than as a broker), leasing, and making investments.

Dealing in goods cannot qualify if the goods are delivered to or from the U.K. or to or from connected or associated persons, unless the goods are actually delivered into the CFC's country of residence.

Dealing in goods wholesale rather than retail, and a variety of other activities including shipping, banking and insurance, qualifies only if less than 50% of the gross trading receipts are derived from connected persons.

The CFC must occupy premises in its country of residence and be able to demonstrate that its affairs are effectively managed there. In certain circumstances a group holding company which is a CFC and whose business is to hold shares in subsidiaries carrying on exempt activities, may qualify for the exempt activities test.

Motive test

This is intended to enable a CFC to demonstrate that it exists for a bona fide commercial purpose and not for the purpose of avoiding U.K. tax.

In practice it is much more difficult to predict whether or not a CFC is likely to satisfy this test. The conditions are very widely drawn, and the test is subjective rather than objective.

It is necessary first for the CFC to demonstrate that avoidance of U.K. tax was not the purpose of its transactions in the accounting period in question, and secondly to show that achieving a reduction in U.K. tax was not the reason for the CFC's existence in the accounting period.

The fact that the meaning of some of the terms in the preceding paragraph is amplified and extended in a Schedule to the Act, adds to uncertainty in attempting to interpret accurately the requirements of the provisions.

Except in a case where the absence of a U.K. tax avoidance motive can clearly be demonstrated, U.K. tax advisers are reluctant to advise that a CFC's operations may continue on the assumption that the motive test will be satisfied.

The Revenue are found to adopt an uncompromising attitude to claims that the motive test is satisfied, particularly in a case where a CFC cannot satisfy the exempt activities test.

GROUP HOLDING AND FINANCE COMPANIES

One of the most common types of company prima facie affected by the legislation is the U.K. group's sub-holding company located in an overseas territory and holding the shares either in all the overseas subsidiaries or in subsidiaries located in a particular part of the world.

It is possible for such a company to escape the effect of the legislation in one of several ways:

(i) It may be located in a listed country, such as the Netherlands. However, as explained in Appendix II, a company will not be entitled to list protection unless 90% of its income is local source. Accordingly, if a Dutch holding company receives most of its income in the form of dividends from subsidiaries in other countries, the list will be of no help.

(ii) As suggested earlier, it may be able to satisfy the exempt activities test if its income is largely derived ultimately from trading subsidiaries carrying on exempt activities. The conditions to be satisfied are extremely complex and difficult to summarize. Broadly, a holding company whose trading subsidiaries are held indirectly through a sub-holding company will not qualify unless the sub-holding company is resident in the same country as its own trading subsidiaries.

Even if a CFC satisfies the special requirements for holding companies it still has to satisfy the other conditions of the exempt activities test relating to the occupation of a building and the management of its affairs in its territory.

(iii) A holding company may be able to satisfy the motive test if it can demonstrate that its function is to receive dividends and interest from operating subsidiaries and on-lend the funds within the group wherever in the world they are required for normal commercial purposes.

A holding company existing for the purpose of averaging the rate of underlying tax for the purpose of U.K. double tax relief on dividends paid to the U.K. could expect to satisfy the acceptable distribution test.

Similarly a group finance company should be able to avail itself of one of the escape routes: for example, a Dutch finance company borrowing funds and on-lending them and paying Dutch tax at 42% on the "turn", would be paying tax at more than half the U.K. rate and consequently would not be a CFC.

APPORTIONMENT OF PROFITS

If none of the exclusion tests is satisfied, it follows that the CFC's profits will be apportioned among those having an interest in the company, and amounts equal to those parts of the profits apportioned to U.K. corporate shareholders will be assessed upon them accordingly, as though they were profits liable to corporation tax.

ATTITUDE OF INLAND REVENUE

The Inland Revenue are pleased with the effects of the legislation so far. Despite the progressive reduction in

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the rate of corporation tax from 52% to 35% which coincided with the introduction of the legislation, the contribution of additional revenue to the Exchequer has been well up to expectations. Most of this additional revenue has been derived from the taxation of dividends paid to satisfy the acceptable distribution test. Although formal directions have been made by the Board of Inland Revenue in a few cases, actual assessment of apportioned profits has been comparatively rare.

The Revenue are anxious to see the legislation operating as smoothly as possible, and a small team of specialists at Head Office is ready to give advice and guidance on the interpretation and application of the law. Head Office involvement is diminishing as local Districts gradually take on more responsibility for the work, but there will always be a role for the specialists at Head Office, since decisions on many areas, such as whether or not the motive test is satisfied, will continue to be referred up. The decision to make a direction will always be exercised by Head Office.

ATTITUDE OF BRITISH INDUSTRY

British industry is learning to live with the legislation. Many groups have availed themselves of the opportunity of taking a fresh look at their tax haven subsidiaries, often set up as part of elaborate tax-planning schemes, and considering whether they still serve the purpose for which they were established. In many cases such subsidiaries had ceased to fulfil their original function, and were existing merely as "money-box" companies, holding surplus funds either invested locally tax-free, or lent around the group. Companies like these are obvious targets for Revenue attack, and in many cases they have been wound up. Some have been made U.K. tax-resident, and as already explained, their surpluses distributed within the U.K. tax-free. There is nothing the Revenue can do to challenge this practice, though a common line of attack is to claim that the company has in fact been U.K.-resident, and its profits accordingly liable to U.K. tax, since its inception.

Many tax haven enterprises, however, continue to exist and, operating within the confines of the legislation, will continue to provide substantial benefits for their groups. There is still ample scope for deferment of U.K. tax through tax haven activities, taking the fullest advantage of the limitations of the statutory provisions and the statutory escape routes.

FUTURE OUTLOOK FOR U.K. TAX HAVENS

The use of tax havens may be adapted to the legislation inter alia in the following ways:

1. Tax at least 50% of U.K. rate

A tax haven may be chosen where profits will be taxed at a rate likely to exceed 50% of the U.K. tax that would be payable if the profits were subject to U.K. tax. For example, any kind of traditional tax haven activity could be carried on by a company resident in Jersey and subject to tax there at 20%. So long as profits for Jersey and for U.K. tax purposes are computed on similar lines, the company would not be a CFC and the legislation would have no application. Tax deferment could be in the region of 15% of the profits per annum. (It should be noted that a company resident, operating and taxable in for example Hong Kong would not be outside the scope of the legislation in the way that a Jersey company would be. This is because of a provision to the effect that a company which is not liable to tax in any country by reason of domicile, residence or place of management is to be "conclusively presumed" to be a CFC and subject to the legislation. Since Hong Kong taxes on a territorial basis and not on the basis of domicile, residence or place of management, a company taxable there is automatically a CFC, and the fact that the effective rate of local tax may be more than 50% of the notional U.K. effective rate is left out of account. The position may be different if the company has a presence or tax liabilities in other territories as well as Hong Kong. Other territories levying tax on an unconventional basis could be in the same situation as Hong Kong.)

2. Legitimate commercial operations

A tax haven could be chosen as a location for carrying on a genuine commercial activity of a type particularly suited to such a location. Such an activity would be carried on within the guidelines laid down for the exempt activities test, and the legislation would have no application, even though no tax was payable on the CFC's profits.

3. "Acceptable" dividend to avoid apportionment

The most popular means of living with the legislation is to cause the CFC to pay a dividend each year equivalent to the prescribed proportion of the profits.

So long as the CFC is carrying on a trade only 50% of the profits need to be distributed. The dividend need not be paid until 18 months after the end of the accounting period. It is taxable to the shareholder for the accounting period in which it is paid, and tax will not be payable by that company until at least 9 months after the end of the accounting period. For example, a CFC may pay a dividend for the accounting period ended 31 March 1987 on 30 September 1988. Tax will be payable by the parent on its profits of the accounting period to 31 March 1989 not earlier than 1 January 1990. Thus tax on half of the CFC's profits for the period ended 31 March 1987 is deferred until 1 January 1990, and tax on the other half is deferred indefinitely.

This is the ideal solution for a captive insurance company, for example, which by definition is incapable of satisfying the exempt activities test.

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CONCLUSION

The CFC legislation is now accepted as a part of the Inland Revenue's comprehensive armoury of anti-avoidance legislation. The tax authorities are content with the additional revenue that is flowing in. From the tax planner's point of view, the legislation has not had quite the devastating effect that its opponents were predicting during the consultation stages: it has not by any means sounded the death knell of tax haven use by U.K. groups. The days of the pure "letter box" type of tax haven company with no real local presence are probably over for multinational groups, but in any case the first line of attack against these by the Revenue wil be a "residence" challenge rather than the CFC legislation. The responsible use of tax havens within the limits of the legislation will still form an important part of U.K. international tax planning, enabling substantial cash benefits to be derived from deferment of tax liabilities in the home country.

APPENDIX I

OUTLINE OF THE LEGISLATION

Companies within the scope of the legislation

The aim of the legislation is to impose U.K. tax on the unremitted profits of certain types of companies which are situated in overseas countries and on whose profits little or no tax is charged.

A company is within the scope of the legislation if in any particular accounting period:

(a) it is resident outside the U.K. for tax purposes, and
(b) it is controlled by U.K. residents, and
(c) it is subject to "a lower level of taxation" in its country of residence.

Such a company is called a "controlled foreign company" (CFC).

The escape routes

Once it is established that a company is a CFC in a particular accounting period, its profits for the period in question will be within the scope of the legislation unless it is able to satisfy the conditions for exemption in relation to that accounting period under at least one of the six escape routes:

(a) The CFC is resident in and carrying on business in a country which is included in the Government-approved "List of Excluded Countries". (If the country concerned is included in Part II of that list, the test is satisfied only if the CFC does not benefit from any of the reliefs specified in that Part.)
(b) The CFC pays a dividend to U.K. residents for the period equal to at least 50% of the profits available for distribution (90% in the case of a non-trading company) – the acceptable distribution test.
(c) The CFC is engaged in "exempt activities" throughout the accounting period. This term is comprehensively defined but it will in general except from the charge a CFC which is carrying on real commercial operations substantially with non-connected parties, or which is a holding company deriving its income from subsidiaries carrying on such operations – the exempt activities test.
(d) It was not one of the main reasons for the CFC's existence in the accounting period to achieve a reduction in U.K. tax by a diversion of profits from the U.K., *and* any reduction in U.K. tax that did result from the CFC's transactions was either minimal or not their main purpose – the motive test.
(e) Ordinary shares carrying at least 35% of the CFC's voting power are beneficially held by the public, and during the accounting period were quoted on, and were the subject of dealings on, a recognised stock exchange in the CFC's country of residence, and the "principal members" of the company do not hold more than 85% of the voting power – the public quotation test.
(f) The chargeable profits of the CFC are not more than £ 20,000 (reduced proportionately if the period is less than 12 months) – the de minimis test.

The liability to tax

If the CFC is unable to satisfy any of the tests, its profits are in principle liable to tax. The CFC itself cannot be assessed, being outside U.K. jurisdiction. The law provides instead for the profits to be assessed on any U.K. resident companies having an "interest" in the CFC. They are taxed in proportion to their interest.

The tax charge applies only to companies, and not to U.K. resident individuals having an interest in the CFC.

The procedure is as follows:

Following investigation, the Inland Revenue make a "direction" that the provisions of the legislation should apply to the CFC for a particular accounting period.

The CFC's "chargeable profits" and "creditable tax" for the period are then calculated, and apportioned among all those who (whether U.K. resident or not, and whether company or individual) had an interest in it at any time during the accounting period.

U.K. resident companies having such an interest are then assessable to tax on a sum equal to corporation tax at "the appropriate rate" on their shares of the apportioned profits, less their shares of the creditable tax for the period, chargeable for the accounting period in which the relevant accounting period of the CFC ends.

Tax is not charged on a U.K. company if the amount of profits apportioned to it, plus the amount apportioned to any other person (company or individual) connected or associated with it, is less than 10% of the total chargeable profits. The Revenue have indicated moreover that it is most unlikely that tax would be charged on a minority shareholder in isolation or even on a number of unconnected minority shareholders unless they were acting in concert.

Chargeable profits in respect of which tax is charged on U.K. resident companies are not to be deemed to be the income of a U.K. resident individual under Section 478 (transfer of assets abroad).

APPENDIX II

LIST OF EXCLUDED COUNTRIES

A list of countries to which the legislation does not apply, or applies only in certain circumstances, is published by the Inland Revenue. It has no statutory force, but may be regarded as a statement of Revenue practice.

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The List is divided into two parts. A company which throughout an accounting period is resident and carrying on business in a country named in Part I will be regarded as meeting the conditions necessary for exclusion from the charge imposed by the legislation. The same applies to a company in Part II of the List, unless the company benefits from any of the reliefs from tax set out in column 2 of that Part.

For the purposes of the List, a company is to be treated as resident in a country if under local law it is liable to tax there by reason of domicile, residence or place of management, but if no country meets this condition, the company will be resident in its country of incorporation.

A company will be regarded as carrying on business in a country if 90% of its commercially quantified income is local source income. "Commercially quantified income" means the profits as determined according to generally-accepted commercial accounting principles, but omitting gains and losses of a capital nature. "Local source income" is income which under local law is treated as accruing in, arising in, or being derived from that country and which is within its charge to tax – i.e., it is actually chargeable there or covered by a specific exemption from the general charge. Dividends from local companies but not subject to tax would be included. The intention is to exclude income which would be taxable under Case V if the company receiving it were resident in the U.K.

For example, a Netherlands holding company may receive dividends from subsidiaries operating in the Netherlands and from other subsidiaries operating in various other countries. Because of the "participation privilege" no tax is paid in the Netherlands. The dividends from Dutch subsidiaries would qualify as local-source income, but the dividends from foreign subsidiaries would not. Unless 90% of the income consisted of dividends from the Dutch subsidiaries, the company would not be excluded by the List.

The List is amended from time to time to take account of tax changes, or where evidence of "exploitation" comes to the Revenue's notice.

Notice of proposed amendments due to tax changes will be given, and comments invited. The amendments, if made, will apply for all accounting periods ending after either:

(a) the date the tax change becomes effective, or
(b) the date notice of the amendment is given,
whichever is the later.

Amendments due to exploitation will apply for all accounting periods ending after the date the amended list is published.

The latest amended List was published on 25 July 1985, and applies to all accounting periods ending after that date. Among the changes were the exclusion of the Netherlands and Belgium from Part I of the List, and their relegation to Part II. The protection of the List is no longer available to Netherlands or Belgian companies regarded as Foreign Sales Corporations for U.S. tax purposes, nor to Belgian Co-ordination Centres.

Any non-trading Netherlands company which obtains a fiscal equity deduction is also excluded. This amendment is aimed at a type of "money-box" company whose only income is derived from the investment of its capital, and whose effective rate of Dutch tax, depending on the rate of interest, could be reduced to a low level by the deduction of a percentage of that capital. Recent legislation however prohibits a deduction for passive investment if that exceeds 50% of total investment, and since the deduction does not apply to investments producing income covered by the participation exemption, this restriction may not have much effect in practice.

Irish companies taxed at nil or low rates on export or manufacturing profits are also in Part II. The exclusion applies specifically to the low or nil-taxed companies themselves: Irish holding companies receiving dividends from such companies would still be protected by the List. Trading companies investing in the new Government securities, interest on which may be tax-free to subsidiaries of foreign companies, are also still covered by Part I.

THE LIST OF EXCLUDED COUNTRIES

Part I: Excluded countries

Australia
Austria
Bangladesh
Bolivia
Botswana
Brazil
Bulgaria
Canada
China
Colombia
Czechoslovakia
Denmark
Dominican Republic
Falklands Islands
Fiji
Finland
France
Gambia
German Democratic Republic
German Federal Republic
Ghana
Honduras
Hungary
India
Indonesia
Italy
Ivory Coast
Japan
Korea, Republic of
Malawi
Mauritius
Mexico
Morocco
New Zealand
Nigeria
Norway
Papua New Guinea
Poland
Romania
Sierra Leone
South Africa (excl. the Homelands)
Soviet Union
Swaziland
Sweden
Thailand
Western Samoa
Yugoslavia
Zambia

Part II: Excluded countries, subject to qualifications

Country	*Qualification*
Argentina	Companies obtaining exemption from tax on income from transactions, activities or operations carried on in, or from goods located in, tax-free areas in accordance with law 19640.
Belgium	1. Companies approved as Coordination Centres under Royal Decree No. 187 of 30 December 1982, or under that Decree as amended by the law of 27 December 1984; 2. Companies which are regarded as Foreign Sales Corporations (FSCs) by the United States and which therefore qualify for reduced Belgian taxation.
Brunei	Companies qualifying as "pioneer companies" under the Investment Incentive Enactment 1975.
Chile	Companies obtaining exemption from tax under Law 16,441 of 1 March 1966 on income from property located in the Department of Isla da Pascua or from activities developed therein.

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Country	*Qualification*
Egypt	1. Companies outside the scope of Article III of Law 157 of 1981 because they do not "operate in" Egypt; 2. Companies to which Articles 16 and 18 of Law 43 of 1974 (as amended by Law 32 of 1977) apply in circumstances where a dividend out of those profits to a U.K. resident company would not attract relief under Article 22(3) of the U.K.–Egypt Double Tax Agreement (SI 1091 of 1980) on account of the proviso to Article 22(3)(b).
Faroe Islands	Companies deriving interest from Faroese financial institutions from which tax is deducted at source under Law 4 of 26 March 1953.
Greece	1. Companies which have profits exempt from tax under Article 6(2)(c) of Law 3843 of 1958 (profits from the operation of ships under the Greek flag); 2. Companies having profits exempt from company income tax by virtue of Article 25 of Law 25/1975 as replaced by Article 28 of Law 814/1978, or by virtue of Law 89/1967 as supplemented by Law 378/1968 (profits from shipping and associated activities).
Ireland	Companies obtaining relief or exemption from tax under Part V of the Corporation Tax Act 1976 or Section 43 of the Finance Act 1980 (profits from trading within Shannon Airport); 2. Companies obtaining relief or exemption from tax under part IV of the Corporation Tax Act 1976 or Section 42 of the Finance Act 1980 (profits from the export of certain goods); 3. Companies obtaining relief or exemption from tax under Chapter VI of the Finance Act 1980 as amended by Section 17 of the Finance Act 1981 (manufacturing companies and their associates).
Kenya	1. Companies having income granted exemption from tax under paragraph 11 Schedule 1 of the Income Tax Act 1973; 2. Companies obtaining investment allowance under paragraph 24(1)(a) or (c) or paragraph 25 Schedule 2 of the Income Tax Act 1973.
Lesotho	Companies obtaining initial, depreciation or investment allowances under Section 18 or the Pioneer Industries Encouragement Act 1969, as amended.
Luxembourg	1. Companies obtaining any special tax benefit under the Law of 31 July 1929, Decree of 17 December 1938 as amended or Grand Ducal Regulation of 29 July 1977 (holding companies); 2. Companies carrying on any reinsurance business.
Malaysia	1. Companies exempt from tax in accordance with Section 54A of the Income Tax Act 1967 (shipping); 2. Companies subject to tax at 5% in accordance with Section 60A of the Income Tax Act 1967 (inward reinsurance); 3. Companies deriving dividends from a company or companies deriving income from one or more of the activities mentioned above.
Malta	Companies entitled to exemption or relief from tax under (a) Section 8(2) of the Income Tax Act 1948; or (b) Section 6B of the Aid to Industry Ordinance 1959.
Netherlands	1. Companies (other than trading companies within Section 91(1) of the United Kingdom Finance Act 1984) obtaining a deduction under Article 14a of the Netherlands Income Tax Law (fiscal equity deduction); 2. Companies which are regarded as Foreign Sales Corporations (FSCs) by the United States and which therefore qualify for reduced Dutch taxation.
Pakistan	Companies deriving royalties, commissions or fees which are exempt from tax under paragraph 139, Part I, second Schedule, Income Tax Ordinance 1979.
Philippines	1. Companies authorized under Presidential Decree 1034 or 1035, both of 30 September 1976, to operate an offshore banking unit or a foreign currency deposit unit as defined in those decrees or the regulations thereto; 2. Companies receiving interest on deposits with a foreign currency deposit unit, or other interest subject to the reduced rates of tax under Section 24(cc) of the National Internal Revenue Code.
Portugal	1. Companies having income not charged to the industrial tax, but would have been so charged had the company been within group A of that tax; 2. Companies which are investment or holding companies having a capital in excess of 100,000 contos, and deriving dividends or interest from Portuguese securities; 3. Companies obtaining the benefit of Article 44 of the Industrial Tax Code (reinvestment or reserves); 4. Companies obtaining a deduction from taxable income under Decree-Law 408/80 of 26 September 1980 (export incentives); 5. Companies obtaining any reduction in industrial, capital or complementary taxes by virtue of the Integrated System of Investment Incentives contained in Decree-Law 194/80 of 19 July 1980, other than by way of accelerated depreciation.
Puerto Rico	1. Companies obtaining full or partial exemption from income tax or surtax under the Industrial Incentive Act 1978, in respect of income from a service industry or from property leased to and used by a business obtaining such exemption; 2. Companies obtaining tax holidays in respect of income from exports, or in respect of the business of maritime transportation of freight or the lease or rental of property used in such transportation.
Senegal	1. Companies receiving income from "bons de caisse" which is not liable to the tax on industrial and commercial profits; 2. Companies obtaining a reduction in the tax

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Country	Qualification
	on industrial and commercial profits by reason of reinvestment of the whole or part of those profits.
Singapore	1. Companies subject to the concessionary rate of tax for insurance and reinsurance of risks outside Singapore by virtue of Section 43C of the Income Tax Act as amplified by the Income Tax (Concessionary Rate of Tax for Income from Insuring and Reinsuring Offshore Risks) Regulations 1980; 2. Companies with Asian currency units having income: (a) taxed at the concessionary rate by virtue of Section 43A of the Income Tax Act as amplified by the Income Tax (Concessionary Rate of Tax for Asian Currency Unit Income) Regulations 1979; or (b) exempt from tax under the Income Tax (Income Arising from Syndicated Offshore Loans) Regulations 1984; 3. Companies obtaining exemption from tax on the income of a shipping enterprise in accordance with Section 13A of the Income Tax Act; 4. Companies obtaining relief from tax in accordance with Sections 37A to K of the Economic Expansion Incentives (Relief from Income Tax) Act, as amended (international trade incentives); 5. Companies obtaining relief from tax in accordance with Sections 46J to S of the Economic Expansion Incentives (Relief from Income Tax) Act as amended (warehouse and service incentives); 6. Companies deriving dividends from a company or companies deriving income from one or more of the activities mentioned above.
Solomon Islands	1. Companies having bank interest exempted from tax by Schedule 1(20) of the Income Tax Act (Chapter 61); 2. Companies carrying on life insurance business exempted from tax by Schedule 1 (26) of the Income Tax Act.
Spain	Companies obtaining tax credit relief for investments under the following or similar laws: (a) Article 32 Law 1 of 1979; (b) Article 34 Law 42 of 1979; (c) Article 40 Royal Decree 3061 of 1979.
Sri Lanka	Companies obtaining relief or exemption from income tax under any of the following provisions of the Inland Revenue Act (No. 28 of 1979): (a) Section 8(c)(iv) – foreign currency banking units; (b) Sections 10(d) and 15(b) – income derived from approved bank accounts; (c) Section 10(e) – interest of newly resident companies; (d) Section 15(cc) – services rendered outside Sri Lanka; (e) Section 15(p) – re-export of approved products.
Tanzania	1. Companies relieved or exempted from income tax under Section 15(1) or (1A) of Income Tax Act 1973; 2. Companies obtaining investment allowances under Schedule II part V of the Income Tax Act 1973.
Trinidad and Tobago	1. Assurance companies carrying on long-term insurance business and liable to corporation tax at 15% on all or part of their profits in accordance with the proviso in Schedule III of the Finance Act 1966; 2. Investment companies as defined by Section 46(3) of the Finance Act 1966 obtaining exemption from corporation tax on profits in accordance with Section 46(1)(b); 3. Approved property development companies entitled in accordance with Section 55A of the Finance Act 1966 to a deduction of 15% of capital expenditure incurred in the construction of a building used for commercial or industrial purposes by a lessee; 4. Companies entitled to a deduction in computing chargeable income, in accordance with Section 2 of the Income Tax (in Aid of Industry) Ordinance 1950 (Chapter 33 No. 2) on the capital expenditure on construction of a building or structure which has been or is to be an industrial building or structure occupied for the purposes of a trade carried on by a lessee; 5. Companies deriving dividends from a company or companies deriving income from one or more of the activities mentioned above.
Tunisia	Companies obtaining exemption from or reduction of tax under Law 76-63 of 12 July 1976 (financial and banking institutions dealing with non-residents).
Turkey	1. Companies obtaining investment incentive allowances under Article 8(9) of Law 5422 of 3 June 1949 and Chapter VIII of Law 202 of 19 February 1963; 2. Companies obtaining export incentives under Article 8(4), (6), (7), (8) or (10) of Law 5422 of 3 June 1949.
United States	Domestic International Sales Corporations as defined in Section 992(a) of the Internal Revenue Code 1954.
Zimbabwe	Companies carrying on a "growth point business" as defined in Schedule 14 of the Income Tax Act 1967 as amended.

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NIGERIA:

Taxation of Dividends

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INTRODUCTION

The 1987 Budget Speech announced the introduction of some important changes in the rules that govern the taxation of dividends in Nigeria. The contents of those measures were not publicised at the time and the relevant Decree is still in the process of preparation, but Major-General Ibrahim B. Babangida, President of the Federal Republic of Nigeria, has now made public the specific measures envisaged. Rather than merely reporting them, the opportunity is taken to review the overall system of taxation of dividends in the country. The recent changes will be discussed within this more general context.

The salient traits of taxation of dividends in Nigeria are the following. A single-rate "classical" system is followed in taxing dividends received by individuals and unincorporated bodies. A company is taxed on its profits and when these profits are redistributed to the company's shareholders as dividends, these are taxed again without taking into account the tax already paid by the company. This strict juristic logic that considers a company as a legal entity fully separated from its shareholders is tempered in the case of dividends received by corporate shareholders; these dividends are considered "franked investment income" and are not taxed again in the hands of the company receiving them. Non-residents are not liable to any tax on dividends distributed by a Nigerian company beyond the 15% withholding tax.

This article considers first some preliminary questions as the different statutory rules that apply to different types of shareholders and the statutory definitions of the expression "Nigerian company". Then the question of what distributions made by a company are taxable is studied. Finally, matters such as the jurisdiction of the Nigerian Revenue in respect of dividends, the system of withholding tax, and the date and place in which the dividend is considered to arise are reviewed.

STATUTORY PROVISIONS APPLICABLE TO DIFFERENT TYPES OF SHAREHOLDERS

There are three sets of statutory rules to be considered:

(1) Rules governing the taxation of dividends received by companies. They are to be found in the Companies Income Tax Act 1979 (CITA 1979), as amended.

(2) Rules governing the taxation of dividends received by individuals and unincorporated bodies resident in Lagos or in the Federal Capital Territory. They are to be found in the Income Tax Management Act 1961 (ITMA 1961), as amended, including the amendments introduced by the Income Tax (Amendment) Act, No. 65 of 1966.

(3) Rules governing the taxation of dividends received by any other individuals and unincorporated bodies. They are to be found in ITMA 1961 as amended to date, excluding the amendments introduced by the Income Tax (Amendment) Act 1966. The reason for this is that this Amending Act specifically provided that, insofar as its provisions related to persons other than companies, it would only apply to the Federal Territory.[1] As this Act introduced some far-reaching amendments to the system of taxation of dividends, the law in this respect has since differed in important respects depending on the State of residence of the taxpayer.[2]

STATUTORY DEFINITIONS OF THE EXPRESSION "NIGERIAN COMPANY"

There are some important differences in the treatment of company distributions according to whether or not they are made by a "Nigerian company". Both ITMA 1961 and CITA 1979 define a company as "any company or corporation . . . established by or under any law in force in Nigeria or elsewhere".[3] But each statute provides a different definition of the expression "Nigerian company". For ITMA 1961, a Nigerian company is any company "the control and management of whose business are exercised in Nigeria".[4] For CITA 1979, a company is Nigerian if it has been "incorporated under the Companies Act 1968 or any enactment replaced by that Act".[5] Therefore, in some cases it may be important to consider whether a given provision in respect of distributions or profits of a Nigerian company is contained in one statute or the other. However, those cases are rather exceptional and in the

1. Sec. 25(2) Income Tax (Amendment) Act, No. 65 of 1966.
2. The rules that determine the territory where an individual or unincorporated body is deemed to reside for tax purposes are to be found in the First Schedule to ITMA 1961. Those persons to whom the Income Tax (Armed Forces and Other Persons) (Special Provisions) Act, No. 51 of 1972 applies – i.e. persons employed in the Nigerian Army, the Nigerian Navy or the Nigerian Air Force; officers of the Nigerian Foreign Service; and persons resident outside Nigeria who derive income or profits from Nigeria: Sec. 1(1) of the Act – follow the same rules that apply to residents in states other than Lagos. A foreign resident in receipt of dividends distributed by a Nigerian company is deemed to be a person to whom the Income Tax (Armed Forces and Other Persons) (Special Provisions) Act 1972 applies: Sec. 12 ITMA 1961, as amended by Act No. 17 of 1973 and Decree No. 4 of 1985.
3. Sec. 2 ITMA 1961; Sec. 78 CITA 1979.
4. Sec. 2 ITMA 1961.
5. Sec. 78 CITA 1979. For the principles to be applied in considering the situs of control of a company see: *Mitchell v. Egyptian Hotels Ltd.* (1915) A.C. 1022; *Aramayo Francke Mines v. Eccott* (1925) A.C. 634; and *B.W. Noble Ltd. v. Mitchell* (1926) 11 T.C. 372.

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great majority of practical situations both definitions produce the same results. A foreign company that wishes to carry on business in Nigeria must do so through a Nigerian subsidiary.[6] If the board of this subsidiary meets in Nigeria – as in practice is always the case – the company will be Nigerian according to both definitions. And the present writer does not know of any company incorporated in Nigeria and carrying on a separate business in a foreign country that is managed and controlled in that country.

It is to be noted, however, that the definition of Nigerian company given in CITA 1979 – unlike that of ITMA 1961 – does not cover statutory corporations. Accordingly for tax purposes the distributions of these statutory corporations are treated in the same way as those of foreign companies.

COMPANY DISTRIBUTIONS SUBJECT TO INCOME TAX

Both ITMA 1961 and CITA 1979 charge dividends specifically to tax.[7] They also provide for the taxation of income or profits in respect of any trade or business[8] and for the taxation of any income or profits not specified in any more detailed charging provision.[9] Accordingly, in order to determine whether a given distribution by a company is taxable in the hands of its shareholders, three questions fall to be considered. In the first place, it has to be determined whether the distribution is a "dividend" and at this point several statutory extensions and restrictions to the ordinary meaning of the term dividend have to be taken into account. If the distribution is a dividend, in the absence of any statutory exemption, it will be taxable; also a number of statutory provisions in respect of dividends – on withholding tax, date and place in which the dividend is deemed to arise, dividends deemed to be derived from Nigeria, and exemptions – will be in principle applicable to the distribution. If a given distribution is not a dividend these statutory provisions will not be applicable, but it will still be subject to income tax if it is an income receipt in the hands of the shareholders and it is not expressly exempted. Finally, even if the distribution considered in itself does not have an income character – e.g. because it is a capital gain – it will still be taxable if it is received as part of the trading or business income of the shareholder and it is not covered by any exemption.[10] Therefore, whenever it is said in this article that a given type of distribution by a company is not taxable in the hands of the shareholders, the statement must be read subject to the qualification that that will be the case provided the receipt of the distribution cannot be considered to be a transaction in the ordinary course of the trade or business of the shareholder. This is relevant, for example, for banks or investment funds.

A dividend can be defined as a distribution by a company to its shareholders in money or money's worth, representing a share of its profits, otherwise than by a return of capital. As McGregor, J., emphasized in *Campbell v. C.I.R. Ltd.*[11]:

> Before any payment can be treated as a dividend it must be distributed out of profits. A return by way of reduction of capital is not a dividend.

The definition offered above makes reference to money's worth. According to general principles income in kind is taxable,[12] but only to the extent to which it is money's worth, i.e. to the extent to which it may be converted into money.[13] A taxpayer on receipt of money's worth will have to pay tax on the fair market value of what he receives.[14] These principles have been applied to cases where companies have paid dividends in kind. As Sankey, J., said in *Pool v. Guardian Investment Trust Co., Ltd.*[15]:

> It is hardly necessary to say that the mere fact that money was not distributed as dividend is not decisive of the question, for money or money's worth may both be liable to income tax.

A distribution made by a company that can be fairly considered a dividend according to the above definition will be taxable. But beyond this general notion of dividend doubts may arise where there is an element of capital receipt in the distribution or where the profits that have funded the dividend are tax-exempt. As in many of those situations the general income tax principles are often modified by statutory provisions, these questions will be examined separately for different types of taxpayers.

(a) Distributions made to individuals or unincorporated bodies resident in Lagos or in the Federal Capital Territory

Where a company makes a capital profit (i.e. a profit derived from the increase in value of any of its capital assets) and that profit is used to fund the payment of a dividend, this dividend will be taxable in the hands of the shareholders as Sec. 4(3)(a) of ITMA 1961 specifically provides that dividend must be understood as including "any profits distributed whether such profits are of a capital nature or not". But where a company is being wound up or liquidated, any profits of a company nature earned before or during the wind-up or liquidation are specifically excluded and will escape taxation. On the other hand, profits distributed by a company in liquidation that are not of a capital nature, whether in money or money's worth, are included in the statutory definition of dividend.[16]

6. Sec. 370 Companies Act 1968.
7. Sec. 4(1)(d) ITMA 1961; Sec. 8(1)(c) CITA 1979.
8. Sec. 4(1)(a) ITMA 1961; Sec. 8(1)(a) CITA 1979.
9. Sec. 4(1)(f) ITMA 1961; Sec. 8(1)(d) CITA 1979.
10. *Californian Copper Syndicate v. Harris* (1905) 5 T.C. 159; *Rees Roturbo Development Syndicate Ltd. v. Ducher* (1927) 13 T.C. 366; *Punjab Co-operative Bank Ltd. v. C.I.T. Lahore* (1940) A.C. 1055; *Cenlon Finance Co. Ltd. v. Ellwood* (1960) 40 T.C. 176.
11. (1968) NZLR 1 at p. 3.
12. *Californian Copper Syndicate v. Harris* (1904) 5 T.C. 159; *Scottish and Canadian General Investment Co. Ltd. v. Easson* (1922) 8 T.C. 265.
13. *C.I.T. v. Maharahadhiraja of Darbhanga* 60 I.A. 146.
14. *Gold Coast Selection Trust Ltd. v. Humphrey* (1948) A.C. 459.
15. *Pool v. Guardian Investment Trust Co. Ltd.* (1922) 1 K.B. 347, at p. 353. See also *Wilkinson v. I.R.C.* (1931) 16 T.C. 52; *Briggs v. I.R.C.* (1932) 17 T.C. 11.
16. Sec. 4(3)(b) ITMA 1961. Introduced by Act No. 65 of 1966.

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ITMA 1961 also stipulates that where bonus shares, debentures or securities are awarded to the shareholders these are deemed to have received as dividend an amount equal to the nominal value of the said bonus shares, debentures or securities.[17] This rule is, however, qualified by a further rule that provides that bonus shares paid as a dividend by a *Nigerian company* are not taxable.[18] It is clear that bonus shares are shares of the company that distributes them and the same applies to bonus debentures. Similarly, bonus securities are only securities – as stock, debenture stock or bonds – of the company that distributes them to its shareholders. This rule has special importance for finance companies that often issue as dividends shares or debentures of *other* companies. These securities are not bonus securities and will be taxed as money's worth, that is, the shareholder will be deemed to be in receipt of an amount equal to their fair market value rather than to their nominal value. This point having been noted, it is still clear that the provisions on taxation of bonus shares, debentures or securities make it possible to avoid tax by issuing securities at a low nominal value, making them convertible into more valuable securities, etc. There is, however, a possible obstacle in the way of this type of schemes as the tax authorities may decide to invoke the powers granted to them by Sec. 14 of ITMA 1961, and challenge the transaction as "artificial" and proceed to "direct that such adjustments shall be made as respects the income . . . as the authority considers appropriate so as to counteract the reduction of liability to tax effected, or reduction which would otherwise be effected by the transaction".[19]

Dividends paid by a company that enjoys or has enjoyed pioneer status out of profits made during its tax holiday period are not taxable in the hands of its shareholders.[20] Where there has been a cancellation of the pioneer status of a company, dividends distributed by it that originally were exempted from tax may suffer tax at any time within six years of such cancellation in order to counteract the tax benefit granted earlier.[21] It is pertinent to point out that while a dividend from a pioneer company is not taxable such dividend may suffer tax where a shareholder company redistributes it. Accordingly, dividends obtained by a company from its subsidiary will be taxable when the company redistributes such funds by way of dividends to its own shareholders.

Dividends paid out of profits on which petroleum profits tax has been paid are also not subject to tax in the hands of the shareholders.[22]

Sec. 19 of CITA 1979 exempts from tax different types of company profits and empowers the Federal Executive Council to grant further exemptions by order. On the basis of general income tax principles, dividends paid out of those profits are taxable as a dividend quite independent from the profits out of which it is paid.[23]

The Nigerian tax code also contains some provisions on companies controlled by small numbers of persons, which are often referred to as "close companies".[24] The shareholders of these companies will often prefer the company not to distribute dividends in order to avoid having to pay tax on them. Even if the profits are not distributed the shareholders will still have the advantage of an increased asset value underlying their shares; will be able to control the way in which the company uses the money; and, may also be able to extract the profits from the company as loans, salaries in future years, etc. To counteract this the Federal Board of Inland Revenue has the power to direct that the undistributed profits of a Nigerian company that is controlled by no more than five persons be treated as if they had been distributed as dividends to the shareholders. As a consequence of such direction the shareholders will be liable to pay tax on the profits deemed to have been distributed in proportion to their shares in the ordinary capital of the company. It should be noted that preferred shareholders will not be affected, and if different classes of shares have different rights to dividends this will be immaterial for the purpose of these provisions.

For the Board to be able to issue a direction the company must have failed to distribute profits that could have been distributed without detriment to the company's business *as it existed* at the end of the accounting period in which the profits were made. But, as another condition precedent to the issuing of a direction, the non-distribution of the profits must be "with a view to reducing the aggregate of the tax chargeable in Nigeria on the profits or income of the company and these persons". Shareholders of companies that retain their profits because of bona fide business reasons should be able to avoid this charge to tax. In any case the Board must issue its direction in respect of the profits of any accounting period of a company not later than 2 years after receiving the duly audited accounts of the company for that period. Only the company – and not the individual shareholders – has a right of appeal in respect of a direction.

There is some doubt on whether the shareholders will face a second charge to tax once the profits that have already been treated as distributed are actually distributed to them. While the position of individual shareholders not resident in Lagos or in the Federal Capital Territory is covered by specific statutory provisions which will be examined later, the Nigerian tax code is silent in respect of the shareholders being considered here. The general principle is that double taxation of the same income is an anomaly,[25] but cogent argu-

17. Sec. 4(3)(a) ITMA 1961. Introduced by Act No. 65 of 1966.
18. Sec. 9(1) ITMA 1961.
19. Nigerian case law is of very little help in determining the meaning to be given to the expression "artificial transaction". Only the case *Aboud v. Regional Tax Board* 1963 W.R.L.R. 18 deals with it, but it provides virtually no useful guidance.
20. Sec. 17 Industrial Development (Income Tax Relief) Act 1971.
21. Sec. 17 Industrial Development (Income Tax Relief) Act 1971.
22. Sec. 51 Petroleum Profits Tax Act 1959.
23. See, for instance, Lord Atkin in *Cull v. I.R.C.* (1940) 22 T.C. 603 at p. 636, approved by Lord Simon L.C. in *Canadian Eagle Oil Co., Ltd. v. R.* (1946) 27 T.C. 205 at p. 248. See also the cases quoted in n.42 infra.
24. Secs. 9(2) and 15 ITMA 1961; Sec. 17 CITA 1979.
25. *Carr v. Foule* (1893) 19 B.D. 251; *Burnes v. Hely-Hutchinson* (1940) A.C. 81 at p. 97; *Executor Trustee and Agency Co. of S.A. Ltd. v. F.C.T.* (1932) 48 CLR 26 at p. 44.

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ments can be advanced both ways and as the point has not been settled in any reported case a final certain solution cannot be given.

It should be noted that the provisions on close companies appear never to have been invoked in Nigeria,[26] but, of course, there is no guarantee that the Nigerian Revenue will remain equally inactive in the future.

(b) Distributions made to other companies

The law governing the taxability of distributions made to companies is, in its general principles, very similar to that regulating distributions to individuals or unincorporated bodies resident in Lagos or in the Federal Capital Territory. The provisions of CITA 1979 on the meaning of the term dividend,[27] non-taxation of bonus shares distributed by a Nigerian company,[28] and artificial transactions[29] are virtually identical to the corresponding provisions of ITMA 1961. CITA 1979 provides specifically that dividends paid out of pioneer profits or out of profits that have suffered petroleum profits tax are not chargeable.[30]

However, there are also some quite significant differences between the tax position in respect of dividends received by a non-corporate shareholder resident in Lagos or in the Federal Capital Territory and that of a company. The most important is that a dividend that has suffered withholding tax and is paid by a Nigerian company to any other company is regarded as "franked investment income" and is not charged to further tax as part of the profits of the company receiving it.[31] In this way double or triple taxation of the same profits is avoided. Moreover, as we will see, the recipient company will also be able to recover by way of set-off the withholding tax which was deducted at source by the paying company.

A company that is not a Nigerian company and is not engaged in a trade or business in Nigeria at any time during a year of assessment[32] will suffer only withholding tax on any dividend that it receives from a Nigerian company. The recipient company has no right to any repayment of the tax withheld that shall be its final tax due in respect of the dividend.[33]

Finally, a dividend distributed by a Nigerian company to any company out of profits exempted from tax by CITA 1979 shall not be taxable in the hands of the shareholder company. Besides those discussed in this article, the most important exemptions contained in CITA 1979 that are relevant to the operation of this provision are the following:

- a portion of the interest received by a bank on any loan granted for the purposes of an agricultural trade of business;[34]
- a portion of the interest received by a bank on any loan granted for the purposes of manufacturing goods for export;[35]
- profits exempted by double taxation agreements;[36]
- interest received from the Federal Savings Bank;[37]
- any profits of any company exempted by order of the Federal Executive Council.[38]

(c) Distributions made to individuals or unincorporated bodies not resident in Lagos or in the Federal Capital Territory

The taxpayers considered in this section include residents in states other than Lagos and persons to whom the Income Tax (Armed Forces and Other Persons) (Special Provisions) Act 1972 applies.[39] Foreign residents in receipt of dividends from Nigerian companies occupy a privileged position within this group: they suffer only withholding tax which becomes the final tax due from them on the dividends.[40] If a foreign resident receives a distribution that is not a "dividend", it will escape tax completely – including withholding tax. On the other hand, if he receives a dividend on which no tax is withheld at source – e.g. a dividend in kind – he will have to pay tax on it in the ordinary way. Accordingly, what is said in the rest of this section is also relevant to foreign residents.

A dividend paid by a Nigerian company out of capital profits to any of the taxpayers being considered in this section is not taxable.[41] A capital profit paid as a dividend by a non-Nigerian company is chargeable to tax. The reason for this is that, in the absence of any statutory provision covering this case, the ordinary concept of dividend will have to be applied and the rule under the general law is that the character of a dividend in the hands of the shareholders is independent of the character of the profits out of which it has been paid. A dividend is an income receipt for the shareholder even if it has been paid out of capital profits. This point was stressed by Lord Russell in *Hill v. Permanent Trustee Co. of New South Wales*[42]:

> A limited company not in liquidation can make no payment by way of return of capital to its shareholders except as a step in an authorized reduction of capital. Any other payment made by it by means of which it

26. G.A. OLAWOYIN; "Tax Treatment of Dividend" in *Proceedings of National Seminar on Tax and Tax Administration*, p. 6, Lagos, 1984.
27. Sec. 8(3).
28. Proviso (i) to Sec. 15 CITA 1979. Amended by Decree No. 4 of 1985.
29. Sec. 18.
30. Provisos (ii) and (iii) to Sec. 15 CITA 1979. Introduced by Decree No. 4 of 1985.
31. Sec. 59B(3) CITA 1979. Introduced by Act No. 98 of 1979. Amended by Decree No. 4 of 1985.
32. The Nigerian year of assessment commences on 1 January.
33. Sec. 16 CITA 1979, as amended by Act No. 98 of 1979 and Decree No. 4 of 1985, together with Sec. 59B CITA 1979, introduced by Act No. 98 of 1979 and amended by Decree No. 4 of 1985.
34. Sec. 9(7).
35. Sec. 9(9). Introduced by Decree No. 4 of 1985.
36. Sec. 33.
37. Sec. 19.
38. Ibidem.
39. See note 3 supra.
40. Sec. 59B(4) CITA 1979. Introduced by Act No. 98 of 1979. Amended by Decree No. 4 of 1985.
41. First proviso to Sec. 9(1) ITMA 1961.
42. (1930) A.C. 720 at p. 731. See also *Re Sechiari* (1950) 1 All E.R. 417; *Re Kleinwort's Settlements* (1951) Ch. 860; *I.R.C. v. Reid's Trustees* (1949) 30 T.C. 431. In *Gimson v. I.R.C.* (1930) 15 T.C. 595, it was held that dividends paid out of capital profits are not taxable. But this depends on the language of the U.K. statutory provisions. There was nothing in the U.K. Income Tax Acts, apart from the company's right to deduct tax, which made dividends specifically liable to income tax. In Nigeria Sec. 4(1)(d) ITMA 1961 charges dividends to tax.

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parts with moneys to its shareholders must and can only be made by way of dividing profits. Whether the payment is called "dividend" or "bonus" or any other name, it still must remain a payment on division of profits.

All distributions made by a company in liquidation – whether they are made out of capital profits or out of trading profits – will escape taxation. This is because there are no statutory provisions and the rule under the general law is that these distributions constitute returns of capital to the shareholders. On the basis of this rule even arrears of preference dividend paid to preferred shareholders in a liquidation have been held to escape tax.[43] The case *C.I.R. v. George Burrell*[44] provides a good illustration of the general principle. The respondent held shares in a number of single-ship companies. On the sale or loss of its ship each of the companies went into voluntary liquidation and its surplus assets, including reserves set aside out of past profits, and other undivided profits, accumulated and current, were distributed by the liquidator among the shareholders. It was held that, on the liquidation of a company, undistributed profits can no longer be distinguished from capital, and that such portion of the assets distributed by the liquidator as represented undistributed profits was not income in the hands of the shareholders.

Where a company capitalizes its profits and applies them in the issue of bonus shares or bonus debentures to its shareholders, this is not a dividend, but a capital payment and, therefore, the shareholders suffer no charge to tax.[45] Even when the debentures are afterwards redeemed by the company, the amounts the shareholders receive are not taxable in their hands.[46] *Aykroyd v. I.R.C.*[47] seems to be an anomalous decision in which bonus debentures payable on thirty days' notice were held to be income and not capital: *I.R.C. v. Fisher's Executors*[48] being distinguished on the ground that the debentures in this latter case were not payable for six years. Although the decision in the *Aykroyd* case can easily be supported on policy grounds as closing a gaping loophole in the law, it is of very doubtful authority on this point as it is plainly inconsistent with earlier authority[49] and was not followed in *Re Outen's Will Trusts*,[50] where it was expressly stated that the probability of the redemption of the debentures was irrelevant to the question whether they were capital or income of the shareholders. Securities of other companies distributed as dividends to the shareholders are taxed as a dividend in kind on their fair market value.

Dividends paid out of profits made by a pioneer company during its tax holiday period; out of profits on which petroleum profits tax has been paid; out of profits that have been deemed to have been distributed to the shareholders of a close company; or out of profits of a Nigerian company that are exempted from tax by CITA 1979, are all exempted from tax in the hands of the shareholders by the provisos to Sec. 9(1) of ITMA 1961. These provisos were deleted by Act No. 65 of 1966, but are still in force for the taxpayers that concern us here.

DIVIDENDS SUBJECT TO TAXATION IN NIGERIA

The income from a dividend distributed by a Nigerian company shall be deemed to be derived from Nigeria[51] and is, accordingly, liable to Nigerian tax.[52] A dividend paid by a foreign company to an individual or an unincorporated body is taxable only to the extent that it is brought into or received in Nigeria.[53] But if an individual is in Nigeria for less than 183 days during the year in which the dividend arises, then he will be exempted from liability to tax on it.[54] A dividend paid by a foreign company to a Nigerian company is always chargeable to tax as Nigerian companies are taxed on their global profits irrespective of whether or not they are brought into or received in Nigeria.[55] Dividends paid by a foreign company to another foreign company are not subject to Nigerian tax even if they are brought into or received in Nigeria.[56] Double taxation relief is available for dividends derived from Commonwealth countries that have reciprocal provisions in their own tax laws, from the Republic of Ireland[57] or from any country with which Nigeria has a double taxation agreement.[58]

In respect of double taxation relief for dividends derived from countries with which Nigeria has a double taxation agreement, there is a material difference between individuals and unincorporated bodies, on the one hand, and companies, on the other. For the first, the underlying profits tax that the foreign company distributing the dividend will have paid is only taken into account, where the relief is given by way of credit, if the double taxation agreement so provides.[59] But in similar cases affecting companies, where the company controls not less than one half of the voting power in the company paying the dividend, the underlying profits tax is always taken into account.[60]

Where there is no double taxation arrangement between Nigeria and another country, an individual or unincorporated body cannot deduct the tax he has paid in that country in respect of dividends derived

43. *Re Dominion Tax and Chemical Co. Ltd.* (1929) 2 Ch. 387.
44. (1924) 9 T.C. 27.
45. For bonus shares: *I.R.C. v. Blott* (1921) 8 T.C. 101; for bonus debentures: *I.R.C. v. Fisher's Executors* (1926) 10 T.C. 302.
46. *C.I.T. Bengal v. Mercantile Bank of India* (1936) A.C. 478.
47. (1942) 24 T.C. 515.
48. See note 44 supra.
49. *Whitmore v. I.R.C.* (1925) 10 T.C. 645.
50. (1963) Ch. 291.
51. Sec. 9(1) ITMA 1961. There is no provision in CITA 1979 that fully corresponds to Sec. 9(1) of ITMA 1961 – Sec. 16 does not cover an identical field – but it is clear on general principles that a dividend paid by a Nigerian company will "derive from" Nigeria as its immediate source is the company, irrespective of where the profits may have been earned.
52. Non-residents only pay withholding tax.
53. Sec. 10 ITMA 1961.
54. Paragraph (x) of the Third Schedule to ITMA 1961.
55. Sec. 11(1) CITA 1979.
56. Sec. 19(1)(k) CITA 1979.
57. Proviso (i) to Sec. 10 ITMA 1961; Sec. 15(b) CITA 1979.
58. Proviso (ii) to Sec. 10 ITMA 1961; Sec. 15(c) CITA 1979. At present, Nigeria is not a party to any double taxation agreement.
59. Sec. 25(5)(c) ITMA 1961.
60. Sec. 34(7) CITA 1979.

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from it when computing its income to be assessed in Nigeria.[61] A company, however, can always deduct foreign income tax on its dividends from other countries where relief from double taxation cannot be given under any other provision of CITA 1979.[62]

DATE AND TERRITORY IN WHICH DIVIDENDS ARISE

Income from a dividend paid by a foreign company to an individual or unincorporated body only arises when the income is brought into or received in Nigeria. Sec. 9(3) of ITMA 1961 provides that in respect of individuals or unincorporated bodies, "the income from a dividend distributed by a Nigerian company shall be deemed to arise on the day on which payment of that dividend becomes due". There is no similar provision for companies, but on general principles companies are taxed on an accrual basis and, therefore, the dividend will be assessed to tax in the year in which it becomes due.[63] This is confirmed by Sec. 59B of CITA 1979 which prescribes that tax shall be deducted at source when the dividend "is paid or credited whichever first occurs". It is well established in Company Law that a dividend becomes due when it is declared unless the company by resolution fixes a later date for payment.[64]

A special case arises where a company distributes to its shareholders as dividends instruments such as promissory notes, post-dated cheques, etc. This is a case of a company distributing "securities" to its shareholders and, therefore, where there are statutory provisions covering the case, an income equal to their nominal value will arise when the distribution is approved. But, as we have seen, this eventuality is not covered by the provisions of ITMA 1961 as they apply to individuals or unincorporated bodies not resident in Lagos or in the Federal Capital Territory. The general law is of application to these taxpayers and the rule is that, when the funding instruments are in reality a promise to pay at a later date, income will only arise when the promise is redeemed. This is so even if the instruments are in the form of easily marketable negotiable instruments. Thus, in *Associated Insulation Products Ltd. v. Golder*[65] an American company – of which the appellant was a shareholder – declared a dividend in 1936, providing that it should not be payable in cash, but in the form of certificates of indebtedness payable in 1940 with interest in the meantime. The certificates were negotiable instruments and the American company reserved the right to pay them off at any time before the due date. It was held that the shareholders' income arose when the certificates of indebtedness were redeemed and not when they were issued.

It may be material, in order to determine the tax authority to which a taxpayer is liable, to decide the state where a dividend arises. Sec. 12 of ITMA 1961[66] stipulates that where the dividend is distributed by a Nigerian company it shall be deemed to be derived from the territory in which the recipient resides. Where the recipient is not resident in Nigeria, he shall be deemed to be a person to whom the Income Tax (Armed Forces and Other Persons) (Special Provisions) Act 1972 applies. In this latter case the relevant tax authority is the Federal Board of Inland Revenue.

WITHHOLDING TAX ON DIVIDENDS

Every Nigerian company is under duty to withhold tax at the rate of 15% from any dividend paid in money and pay over the amount withheld to the tax authorities. The amount is payable to the Federal Board of Inland Revenue where the shareholder is a company or any person to whom the provisions of the Income Tax (Armed Forces and Other Persons) (Special Provisions) Act 1972 apply.[67] In the case of dividends payable to any other taxpayer, the amount deducted at source is payable to the "relevant tax authority" as determined by the First Schedule to ITMA 1961.[68] The tax is to be deducted and paid over to the Revenue when the amount is paid or credited, whichever occurs first.[69] Shareholders resident in Nigeria include in their income return the gross amount of the dividend[70] and their tax is computed accordingly, but they have the right to set off the amount deducted at source against their tax payable.[71] If the amount deducted at source is larger than the shareholder's tax liability for the relevant year of assessment, a refund can be claimed from the Revenue.[72] Although, in practice refunds tend to be quite difficult to obtain and the surplus deducted is usually set off against the tax due on the following year. Withholding tax is the final tax due from a non-resident shareholder.[73] Accordingly, non-residents do not have to include the dividend in their income return if they are in receipt of any other chargeable income, nor are they entitled to claim any refund.

Where a company receives a dividend after deduction at source of the withholding tax, this dividend is regarded as franked investment income and is not charged to further tax in the hands of the recipient company. Moreover, when such dividend is later redistributed to the recipient company's shareholders and the company incurs a liability (to the Revenue) for the

61. Sec. 18(e) ITMA 1961. However, as the tax is only chargeable on the income "brought into or received in Nigeria", if the dividend is brought into Nigeria net of tax, the foreign tax will have been deducted in practice.
62. Sec. 22(c) CITA 1979.
63. *C.I.R. v. Whitworth Park Coal Ltd.* (1959) 38 T.C. 531; *I.R.C. v. Gardner, Mountain and D'Ambrumeneil Ltd.* (1947) 29 T.C. 69.
64. *Bond v. Barrow Heametite Steel Co.* (1902) 1 Ch. 353; *Re Accrington Corporation Steam Tramways Co.* (1909) 2 Ch. 40.
65. (1944) 26 T.C. 231.
66. As amended by Act No. 17 of 1973 and Decree No. 4 of 1985.
67. See note 3 supra.
68. Sec. 59B CITA 1979 and Sec. 21E ITMA 1961, both introduced by Decree No. 4 of 1985; Sec. 30(6) CITA 1979.
69. Sec. 59B(1) CITA 1979 and Sec. 21E(1) ITMA 1961, both introduced by Decree No. 4 of 1985.
70. Sec. 9(1) ITMA 1961 as amended by Decree No. 4 of 1985; Sec. 15(a) CITA 1979.
71. Sec. 26(1) ITMA 1961; Sec. 31(1) CITA 1979 as amended by Decree No. 98 of 1979.
72. Sec. 26(1) ITMA 1961; Sec. 31(2) CITA 1979 as amended by Act No. 98 of 1979.
73. Sec. 59B(4) CITA 1979. Introduced by Decree No. 4 of 1985.

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tax withheld, the company may offset the withholding tax which it has itself suffered on the same income.[74]

A company which fails to deduct tax as prescribed or to pay it to the relevant tax authority within 30 days from the date the amount was deducted or the time the duty to deduct arose commits an offence punishable by a fine of ₦ 5,000. The company is also liable to pay interest at the prevailing commercial rate in cases of delay.[75]

THE 1987 MEASURES

It has recently been announced[76] that, as from 1987, dividends accruing to an individual or a company shall be free of tax for a period of three years where the three following conditions obtain:

(a) the company paying the dividends is incorporated in Nigeria:
(b) the equity participation is imported into the country between 31 January 1987 and 31 December 1992; and
(c) the recipient's equity in the company constitutes at least 10% of the share capital of the company.

Should the company paying the dividends be engaged in agricultural production or processing of Nigerian agricultural products produced within the country or production of petrochemicals or liquefied natural gas, the tax-free period shall be five years.

CONCLUSION

While it would be out of place in an article of this nature to discuss in detail possible modifications to the law as it now stands, it may be opportune to draw attention to one major point in need of reform. The law on the taxation of dividends would be simpler, fairer and more certain in its administration if the differences in treatment of taxpayers according to their territory of residence were eliminated.

In 1966 Nigeria was at a very delicate point in its constitutional history. There were grave tensions between the regions, and between the regions and the Federal Government, that were soon to result in the Nigerian Civil War. In the circumstances, a good measure of self-restraint in the exercise of the powers of the Federal Government was obviously required. Also, the economic circumstances of Lagos at the time were very different from those prevailing in the rest of the country. Therefore, it was probably justified to restrict the application of Act No. 65 of 1966 to those taxpayers that were under the jurisdiction of the Federal Board of Inland Revenue, i.e. companies throughout the Federation and individuals and unincorporated bodies resident in the Federal Territory. But the situation has changed substantially since 1966. The differences between Lagos and other Nigerian cities are no longer what they used to be and, since 1975, it has been the declared policy of the Federal Government to create uniformity of tax burdens throughout Nigeria. A first important step in this direction was the promulgation of the Uniform Taxation Provisions Decree in 1975 introducing uniformity of tax rates and personal allowances. Further steps in the same direction were taken by placing income tax matters in the Exclusive Legislative List of the 1979 Constitution and by undertaking the preparation of a Uniform Personal Tax Law for the country. In this context the retention of the differences in the treatment of taxpayers according to their territory of residence that were introduced in 1966 appears very difficult to justify on either systematic or policy grounds. The application of Act No. 65 of 1966 to the whole country is therefore recommended.

74. Sec. 59B(3) CITA 1979. Introduced by Decree No. 4 of 1985.
75. Sec. 21F ITMA 1961 and Sec. 59D CITA 1979, both introduced by Decree No. 4 of 1985.
76. Statement by Major-General I.B. Babangida in a special supplement on Nigeria in *Time Magazine*, 2 March 1987.

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INDIA:

Decline of Direct Taxes

By M.M. Sury*

ABSTRACT

The steady decline in the share of direct taxes in Central Government tax collections is a disquieting feature of India's tax structure in the post-Independence period. In spite of a variety of income and capital taxes and modernization of the economy, direct taxes are losing to indirect taxes as revenue earners. Why has the proportion of direct taxes been falling? What are Government's protestations in this regard? What is the present state of affairs? These are some of the issues discussed in this article.

The Indian tax system has undergone some major structural changes since Independence. One such change is the gradual but significant decline in the relative importance of direct taxes in Central Government's tax collections. This disturbing trend has made the present tax structure lop-sided and iniquitous.

Table 1 reveals that in 1950-51, direct taxes accounted for a sizeable 43.2% of total Central tax collections: 174 crore Rs.[1] out of 404 crore Rs. Within a span of 30 years the proportionate share dropped to almost half at 22.8% in 1980-81. The declining trend of direct taxes led to a rising share of indirect taxes. The ratio between direct and indirect taxes which stood at 43.2:56.8 in 1950-51 worsened with every passing decade, recording 32.6:67.4 in 1960-61, 27.1:72.9 in 1970-71 and 22.8:77.2 in 1980-81. In the Budget for 1987-88, the picture is still dismal. The relative shares of direct and indirect taxes have been estimated at 6,615 crore Rs. (17.9%) and 30,302 crore Rs. (82.1%), respectively, out of a total estimated tax yield of 36,917 crore Rs.

In connection with the diminished role of direct taxes, the Seventh Five Year Plan noted:[2]

> Contrary to the expectation that with economic development the ratio of direct to indirect taxes would increase, as a result of poor performance of direct taxes the Government has been forced to rely increasingly on indirect taxes, which rose from 11.7% of GDP at market price in 1975-76 to 14.0% in 1984-85, while direct taxes fell from 3.4% to 2.3% during the same period.

It is customary to explain the limited role of direct taxes in developing countries in terms of their peculiar circumstances which include a large agricultural sector of a subsistence nature, small-scale industrial activities, a lack of monetization and accounting practices, and low levels of income. In addition to these underlying reasons, a host of specific factors have also contributed to the reduced role of direct taxes.

These include: (a) a scaling down of rates of direct taxes; (b) a plethora of exemptions/concessions; and

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1. 1 lakh = 0.1 million, and 1 crore = 10 million. At the current (March 1987) rate of exchange 1 pound sterling = Rs. 20, and 1 U.S. dollar = Rs. 13 approximately.
2. Government of India, Planning Commission, *The Seventh Five-Year Plan* (1985-90), Volume 1, para. 4.60.

Table 1
Trends in the relative shares of direct and indirect taxes 1950-51 to 1987-88, selected years
(Rs. crore)

Year	Total Central tax collections	Direct taxes			Indirect taxes			Ratio between cols. 5 and 8
		Income	Corporation	Total*	Excise	Customs	Total**	
1	2	3	4	5	6	7	8	9
1950-51	404	132	40	174	68	157	230	43.2:56.8
1955-56	483	131	37	170	145	166	314	35.0:65.0
1960-61	888	166	111	290	414	170	599	32.6:67.4
1965-66	2,060	271	304	602	898	539	1,457	29.2:70.8
1970-71	3,206	473	371	870	1,759	524	2,337	27.1:72.9
1975-76	7,608	1,214	862	2,205	3,845	1,419	5,403	29.0:71.0
1980-81	13,179	1,506	1,310	3,004	6,500	3,409	10,175	22.8:77.2
1985-86	28,671	2,509	2,865	5,657	12,956	9,526	23,014	19.7:80.3
1986-87 (R.E)	32,671	2,764	3,330	6,274	14,347	11,500	26,397	19.2:80.8
1987-88 (B.E)	36,917	2,845	3,537	6,615	16,826	12,867	30,302	17.9:82.1

* Total includes collections from estate duty, wealth tax, gift tax and some other taxes of minor revenue significance.
** Total includes collections from State excises, taxes on vehicles, sales tax, octroi, entertainment tax and some minor taxes levied in Union Territories without legislature.

Source: Government of India, Ministry of Finance, *Explanatory Memorandum on the Budget of the Central Government* (Various years).

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(c) ineffective administration. To this list may be added the problem of tax evasion. A brief explanation of each of these factors is as follows:

DECLINING RATES

Pursuant to the recommendations of the Direct Taxes Enquiry Committee (DTEC), 1971, the Government initiated a series of rate reductions in direct taxes. Table 2 summarizes the decline in the maximum marginal rates of income tax and wealth tax beginning with the year 1974-75. The maximum marginal rate of personal income tax was reduced from 97.7% in 1973-74 to 77% in 1974-75, and further down to 66% in 1976-77. It is noteworthy that DTEC had recommended a maximum marginal rate of 75%. As in the case of income tax, the top marginal rate of wealth tax was also lowered from 8% in 1973-74 to 2.5% in 1976-77.

The downward trend in the rates of direct taxes was temporarily reversed during the brief Janata Government rule at the Centre. As is discernible from Table 2, the maximum marginal rate of income tax was increased from 66% in 1976-77 to 69% in 1977-78, and further up to 72% in 1979-80. The maximum marginal rate of wealth tax was also jacked up from 2.5% in 1976-77 to 3.5% in 1977-78, and to 5% in 1979-80.

However, the policy of low direct tax rates of the Congress Government started in 1974, and carried forward in 1976, was further reinforced after it came back to power at the Centre in 1980, and it has continued till date. After a series of reductions, the present maximum marginal rate of personal income tax stands at 50% and that of wealth tax at 2%. Also, the basic rate of income tax in the case of corporations was reduced by 10 percentage points, from 65% to 55% in the Budget for 1985-86.

Table 2
Trends in the maximum marginal rates of personal income tax and wealth tax

Year	Top marginal rate of personal income tax including surcharge (%)	Top marginal rate of wealth tax (%)
1973-74	97.7	8.0
1974-75	77.0	,,
1975-76	,,	,,
1976-77	66.0	2.5
1977-78	69.0	3.5
1978-79	,,	,,
1979-80	72.0	5.0
1980-81	66.0	,,
1981-82	,,	,,
1982-83	,,	,,
1983-84	67.5	,,
1984-85	61.9	,,
1985-86	50.0	2.0
1986-87	,,	,,
1987-88	,,	,,

Notes: 1. The maximum marginal rate of personal income tax is applicable to income over 1 lakh Rs.
2. The maximum marginal rate of wealth tax is applicable to net wealth above 15 lakh Rs.

Source: Government of India, Budget papers, *speeches of Finance Ministers* (various years).

Till 1985-86 the rate structure of gift-tax was quite progressive, ranging between 5% on the value of taxable gifts not exceeding 20,000 Rs. and 75% on the value of taxable gifts in excess of 20 lakh Rs. However, in the 1986-87 budget this wide range was replaced by a 30% flat rate tax. Under the present law whether one makes a taxable gift of 20,000 Rs. or 20 lakh or even 2 crore Rs., the rate of gift tax remains the same, i.e. 30%. To cap it all, estate duty was abolished altogether effective 16 March 1985.

EXEMPTIONS/CONCESSIONS

The second reason for the decline in the proportion of direct taxes is the liberal concessions accorded under law to assessees of income tax, wealth tax and gift tax. The statutory rates of income tax and other direct taxes are illusory if account is taken of the various exemptions/deductions which lower significantly the effective rates of taxation. These "tax expenditures" have the combined effect of eroding the tax base and impairing the progressivity of the tax system. Little surprise if the total number of income taxpayers has been stagnating at about 40 lakh for many years, representing 1.5% of the country's working population.

INEFFICIENT TAX MANAGEMENT

The third factor viz., inefficient tax administration, is evident from the meagre revenue collections from wealth tax, gift tax and estate duty. As is clear from Table 3, these three "paper taxes" have never been of much significance in terms of revenue yield. Their combined share in the total taxes declined from 1.36% in 1960-61 to 0.79% in 1970-71, and further down to 0.68% in 1980-81. The contribution of wealth tax, gift tax and left over of estate duty put together accounts for a mere 141 crore Rs. (0.38%) in a total tax collection of 36,917 crore Rs. budgeted for the year 1987-88. Table 3 reveals also that the combined share of the three taxes in direct tax collections plummeted from 4.17% in 1960-61 to 2.93% in 1970-71, and is estimated at 2.13% in the Budget for 1987-88. Though non-entities from revenue standpoint, these decorative taxes give wrong signals of tax burden on the well-to-do classes.

TAX EVASION

Finally, large scale tax evasion has contributed to the poor performance of direct taxes. The underlying

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philosophy of soft rates has been to promote tax compliance to control black money. In many cases tax rates were reduced under the pressure of lobby groups in the name of better compliance. One oft-repeated argument of these groups has been that high tax rates increase premium on tax evasion which, in turn, generates black money.

However, statistical evidence is lacking to support the contention that reduced rates have checked the growth of concealment of incomes. On the contrary, recent estimates of black money are staggering and possibly suggest growth of black incomes with decreasing direct tax rates. The National Institute of Public Finance and Policy in a recent report on "black economy" in India has concluded:[3]

> Thus, where the ratio of tax-evaded income to GDP was estimated to range from 3.7% to 5.7% in 1975-76, the corresponding range in 1980-81 is between 4.2 and 8.6%.

With GDP at current prices and factor cost being 1,14,271 crore Rs. in 1980-81, the range of tax-evaded income amounted to between 4,799 crore Rs. to 9,827 crore Rs. in that year. Applying an average income tax incidence of 35%, the income tax evasion in 1980-81 ranged between 1,679 crore Rs. and 3,439 crore Rs. It may be recalled that income tax collections in 1980-81 totalled 1,506 crore Rs. (Table 1).

Surely, India has come a long way since the days of Nicholas Kaldor who estimated, in 1956, income tax loss through tax evasion at 200 to 300 crore Rs. for the year 1953-54.[4] Fifteen years later the amount roughly doubled when the DTEC (1971) established the income on which tax was evaded for 1968-69 at 14,000 Rs. crore and the amount of tax evasion at 470 Rs. crore for the same year.[5] Evasion is not restricted only to income tax, but extends to other direct taxes also. The ridiculously low yields from wealth tax and gift tax are partly due to a plethora of exemptions/deductions and partly due to wide-spread evasion.

GOVERNMENT'S VIEW AND BUDGETARY TRENDS

The direct tax trends caused a flutter in the Government circles and a feeling of concern was expressed in official documents. The Long Term Fiscal Policy while seeking to correct the imbalance maintained:[6]

> An important objective of fiscal policy must be to reverse the decline in the share of direct taxes over the long term.

To be more specific, it projected the share of direct taxes to increase from 1.5% of GDP to 2.1% over the Seventh Plan period. The contribution of indirect taxes was projected to grow from 6.3% to 7.3% of GDP over the same period. With the help of these projections the ratios between direct and indirect taxes have been computed in Table 4. These ratios have been compared with actual performance during the first 3 years of the Plan on the basis of the data made available in the Budget for 1987-88. A disturbing variation is noted between official projections and budgetary trends. For the year 1985-86, the ratio between direct and indirect taxes (net of States' share) was projected at 19.2:80.8 but the actual figures for the

3. Government of India, Ministry of Finance, *Aspects of the Black Economy in India*, March 1985, p. 161.
4. Nicholas Kaldor, *Indian Tax Reform – Report of a Survey* (Government of India, Ministry of Finance, 1956), p. 105.
5. Government of India, Ministry of Finance, *Final Report of Direct Taxes Enquiry Committee*, December 1971, pp. 7-8.
6. Government of India, Ministry of Finance, *Long Term Fiscal Policy*, (December 1985), para. 4.4.

Table 3
Relative significance of wealth tax, gift tax and estate duty in Central tax collections: selected years
(Rs. crore)

Year	Total Central tax collections	Central Direct tax collections	Collections from				Col. 7 as percent of	
			Wealth tax	Gift tax	Estate* duty	Total 4+5+6	Col. 2	Col. 3
1	2	3	4	5	6	7	8	9
1960-61	888	290	8.1	0.9	3.1	12.1	1.36	4.17
1965-66	2,060	602	12.1	2.3	6.6	21.0	1.02	3.48
1970-71	3,206	870	15.3	2.4	7.8	25.5	0.79	2.93
1975-76	7,608	2,205	53.7	5.1	11.6	70.4	0.92	3.19
1980-81	13,179	3,004	67.4	6.5	16.3	90.2	0.68	3.00
1985-86	28,671	5,657	153.0	12.0	23.0	188.0	0.65	3.32
1986-87 (R.E)	32,671	6,274	125.0	11.0	13.0	149.0	0.46	2.37
1987-88 (B.E)	36,917	6,615	120.0	11.0	10.0	141.0	0.38	2.13

* Estate duty was abolished w.e.f. 16 March 1985. Revised estimates for 1986-87 and Budget estimates for 1987-88 represent likely collections on estates passing on deaths occurring before the abolition.

Source: Government of India, Ministry of Finance, *Explanatory Memorandum on the Budget of the Central Government* (Various years).

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same year show it at 17.9:82.1. Similarly, the projected ratio between the two categories of taxes is 20.7:79.3 for the years 1986-87 and 1987-88 whereas it has turned out to be 16.8:83.2 for the year 1986-87 (revised estimates) and 15.5:84.5 for 1987-88 (Budget estimates). These deviations of budgetary trends cast a serious reflection on Government's protestations.

CONCLUSION

The subdued and declining role of direct taxes in a developing country has serious equity implications. Indirect taxes, levied on a wide spectrum of goods and services including necessities, do not allow considerations for the personal circumstances of the taxpayers as do direct taxes. The distribution of indirect tax burden is often, though not always, regressive and even the poorest of the poor are made to contribute to the public exchequer. The decline in the relative significance of direct taxes needs to be arrested and reversed as envisaged in the Long Term Fiscal Policy. It calls for restructuring of direct tax laws and their effective implementation.

Table 4
Projections and budgetary trends of Centre's direct and indirect tax revenues

Year	Projections of Centre's tax revenue net of States' share (as per cent of GDP at 1984-85 prices)			Ratio between col.3 and col. 4	Budgetary trends of Centre's tax revenue net of States' share (Rs. crore)			Ratio between col. 7 and col. 8
	Total	Direct	Indirect		Total	Direct	Indirect	
1	2	3	4	5	6	7	8	9
1985-86	7.8	1.5	6.3	19.2:80.8	21,180	3,791	17,389	17.9:82.1
1986-87	8.2	1.7	6.5	20.7:79.3	24,207*	4,074	20,133	16.8:83.2
1987-88	8.7	1.8	6.9	20.7:79.3	27,711**	4,291	23,420	15.5:84.5
1988-89	9.2	2.0	7.2	21.7:78.3	—	—	—	—
1989-90	9.4	2.1	7.3	22.3:77.7	—	—	—	—

* Revised estimates
** Budget estimates

Source: For columns 2, 3 and 4, *Long Term Fiscal Policy* (December 1985), p. 13, Table 4 (excepted); for columns 6, 7 and 8, Government of India, *Budget Papers*, 1987-88.

Conference Diary

JULY 1987

European Study Conferences Limited: Tax and Company Aspects of Corporate Reorganisation. London, 2 July (English).

European Study Conferences Limited: Tax & Legal Aspects of Directors' Rewards. London, 7 July (English).

Prentice Hall Law & Business: Fourth Annual: Structuring Partnership Agreements. Vail, Colorado, 23-24 July (English).

SEPTEMBER 1987

International Fiscal Association: The Fiscal Residence of Companies; Tax Problems of the Liquidation of Companies; Taxes and Human Rights (Seminar). Brussels, 6-11 September (English, French, German, Spanish).

International Bar Association, Section on business law: National Tax Developments, Taxes and High Tech Operations, Taxes and International Venture Operations, the Issue of International Securities. London, 14-18 September (English).

International Tax Planning Association: Change or Residence: Individuals; Monte Carlo Workshop. Monte Carlo, 17-18 September (English).

Prentice Hall Law & Business: Fourth Annual: Structuring Partnership Agreements. Los Angeles, 17-18 September (English).

Bureau of European Taxation and Trade: Symposium on the Taxation of Directorship in Europe. London, 28 September 1987.

FOR FURTHER INFORMATION PLEASE WRITE TO:

Bureau of European Taxation and Trade, Att.: Ms. Audrey Evelyn Bone, 606 Bryer Court, Barbican, City of London, EC2Y 8DE, United Kingdom.

European Study Conferences Limited, Kirby House, 31 High Street East, Uppingham, Rutland, Leicestershire LE15 9PY, United Kingdom.

International Bar Association, Section on business law, 2 Harewood Place, Hanover Square, London W1R 9HB, United Kingdom.

International Fiscal Association, General Secretariat, P.O. Box 1738, 3000 DR Rotterdam, Netherlands.

International Tax Planning Association, Att. Elizabeth Walters, I.T.P.A. Membership and Conference Liaison Office, 33A Warwick Square, London SW1V 2AQ, United Kingdom.

Prentice Hall Law & Business, 855 Valley Road, Clifton, NJ 07013, U.S.A.

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INDIA:

Income Tax Incentives – Harnessing Corporate Skills for Rural Development

By H.K. Sondhi

The National Institute of Public Finance and Policy, New Delhi, has completed a study of the Rural Development Allowance – India's income tax incentive to directly involve the corporate sector in rural uplift. It is of interest to both the developing and developed countries. This article gives a synopsis of the study.

Since nearly ¾'s of India's population lives and works in rural areas, the majority of it at low levels of income and consumption, development of these areas is a cornerstone of the country's planning strategy. Massive outlays on irrigation, rural electrification, communications and creation of financial infrastructure for the growth of agriculture and rural industries have been the principal instruments of this strategy. The tax system has also been used in various ways to lend support to this strategy. For instance, protection and development of handlooms has been a major element of the textile policy, and products of cottage and village industries have, in general, been free of excise duties. On the direct taxes side, income of various Government and non-profit agencies engaged in the development of village industries is exempt from tax. In addition to the tax holiday for the newly established industrial undertakings and hotels, irrespective of their location (Section 80J/80I of the Income-Tax Act, 1961 hereafter referred to as the "Act"), a scheme of partial exemption of the profits of new industrial undertakings established in backward areas has been in operation since 1974 (Section 80HH). An alternative concession for newly established industrial undertakings in rural areas is also on the status from 1977 (Section 80HHA). The introduction of tax credit certificates for the shifting of industrial undertakings from urban areas (Section 280ZA) is also in a way a measure for industrialization of rural areas. Apart from these, a few provisions of a distinctive character were introduced in the 1960s and 1970s which were designed to promote the development of rural areas through the application of modern technology in agriculture and the spread of social services. These were the Agricultural Development Allowance (Section 35C), the Rural Development Allowance (Section 35CC) and the deduction for funding of rural development programmes through approved associations and institutions (Section 35CCA) inserted in the Act in 1968, 1977 and 1978, respectively.

The distinguishing feature of the latter provisions was that unlike the tax holiday or exemption related to the source of income, these were linked to the use or application of income in the desired directions, irrespective of whether these happened to be within the field of business activity of the taxpayer concerned. The agricultural development allowance (Section 35C) permitted manufacturers (companies and cooperatives) using products of agriculture, animal husbandry, dairy or poultry farming as raw materials to claim a deduction (a weighted deduction of 120% for some years) from their taxable income for expenditures incurred by them in providing goods, services and other facilities to cultivators, growers and producers to raise their productivity. While the Rural Development Allowance (Section 35CC) provided for deduction of expenditures incurred by companies and cooperative societies in undertaking approved rural development programmes on their own, Section 35CCA allowed any taxpayer carrying on a business or profession to claim a deduction in respect of funding of approved programmes of rural development or training of personnel for their implementation through approved associations and institutions. In addition, by Section 80GGA inserted in the Act in 1979, donations for the above purposes by taxpayers not carrying on a business or profession also became entitled to tax relief.

While all these provisions subserved the objective of rural development, a feeling grew that there was considerable overlap among them. Also, doubts were felt about their efficacy vis-à-vis their cost in terms of revenue forgone, and the attendant complications in tax law. Hence, in line with the policy of simplifying tax laws and removing ineffectual or wasteful incentive provisions, the Agricultural Development Allowance (Section 35C), the Rural Development Allowance (Section 35CC) and the deduction for funding of programmes through approved associations and institutions (Section 35CCA) have since been withdrawn. Only contributions or donations made by taxpayers to the National Fund for Rural Development, set up in 1984, are deductible in computing taxable income.

In order to evaluate the costs and benefits of incentives

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of this nature, the present study was commissioned by the Central Board of Direct Taxes of India in respect of one of the incentives for rural development: the Rural Development Allowance provided under Section 35CC of the Act.

ESSENTIAL FEATURES

Section 35CC was inserted in the Act with effect from 1 September 1977 and was taken off the statute on 17 March 1985. The essential features of this incentive provision were:

- only companies and cooperative societies could avail of the incentive. The interested company or cooperative society had to draw up specific programme(s) of rural development for one or more rural areas;
- to secure a deduction of the expenditure incurred on a rural development programme in the computation of total income, the programme had to be approved by the prescribed authority before incurring any expenditure thereon. From 1 September 1977 till 31 May 1979 the prescribed authority was a Central Interministerial Committee with the Secretary, Union Department of Agriculture as its chairman. To expedite clearance of schemes of rural development, the work relating to approval of programmes was decentralized from 1 June 1979 and entrusted to State level committees consisting of the Commissioner of Income Tax exercising jurisdiction over the State or Union Territory in which the programme was to be carried out, as the chairman, and the concerned secretary of the State government or Union Territory as a member;
- "programmes of rural development" was defined as including any programme for promoting the social and economic welfare of, or the uplift of, the public in any rural area. The Central Interministerial Committee drew up an illustrative list of 15 categories of programmes that would be considered by it for approval (Appendix I). This illustrative list was also followed by the State-level committees. Following the amendment of Section 35CC by the Finance Act, 1983, w.e.f. 1 April 1983 the prescribed authority could approve only those programmes which fell within the classes or categories of programmes specified by the Central Government (Appendix II);
- while according approval to a programme, the prescribed authority laid down the period during which it had to be implemented. Ordinarily, the implementation period was from the date of approval by the prescribed authority till the close of the accounting year of the taxpayer commencing next after that date. Before approving an extension, the prescribed authority could monitor the programme to satisfy itself that it was being implemented properly;
- if the programme involved construction or acquisition of any building, machinery or plant or furniture, the taxpayer had to divest itself of the ownership of the asset in favour of the village "panchayat" (village council) or other local authority. On its failure to do so, it was not entitled to a deduction in respect of the expenditure incurred thereon and could only get depreciation on the cost of the asset, as if it was a business asset;
- a claim for deduction under Section 35CC was admissible only if the taxpayer furnished a statement of expenditure in a prescribed form duly signed and verified by a qualified accountant. This statement was to be filed along with the return of income for the assessment year in respect of which the deduction was claimed.

COOPERATIVE SECTOR

A cooperative's capacity to spare funds and human resources for a project which is not an essential part of its day to day operations is very limited. Cooperatives making substantial profits enjoy many tax concessions and their contribution to income tax revenues is relatively small. It was therefore no surprise that the response of the cooperative sector to this incentive was found to be negligible. The study was therefore confined to the corporate sector.

EXTENT OF CORPORATE RESPONSE

The number of companies borne on the registers of the Indian Income Tax Department on 31 March 1983 was 48,597. Only the relatively more prosperous of them could be expected to take on the burden of rural development. The study determined the total number of companies which got their programmes approved under Section 35CC at 155. This works out to 5.3% of 2,928 (the number of companies with income above 0.5 million Rs.) Even allowing for the fact that a large number out of 2,928 companies would be enterprises with operations entirely restricted to urban areas with little interest in villages, it is evident that the corporate sector's response to the incentive was lukewarm. Moreover, not all the companies which had programmes approved undertook their implementation. There was a drop out rate of about 20%. Further, about 1/3 of the companies which availed of the incentive lost interest in it after implementing a relatively modest programme the cost of which did not exceed 0.2 million Rs.. In other words, the little initial enthusiasm for the incentive soon tapered off. The poor response to the scheme is further evidenced by the fact that the total expenditure incurred in the approved programmes which were actually executed is estimated at 90 million Rs. and the tax revenue forgone on its account at 50 million Rs., forming only about 0.35% of the income tax collected from the corporate sector during the relevant period.

Available information showed that over 86% of the total amount of deductions claimed under Section 35CC was by 60 companies which belonged to the larger companies established in India. Inadequacy or absence of profits in a particular year was no constraint on their capacity to run such programmes since the

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size of the outlay was relatively small. As much as 38% of the entire investment under Section 35CC was made by companies belonging to one of the Large Industrial Houses.

It was also significant that several of the companies which availed of this incentive had been running rural welfare programmes even earlier. Whether, and if so, to what extent, the incentive spurred them to put in further efforts in this direction is difficult to say. However, the fact that the outlay for which deductions were claimed was no more than 90 million Rs. indicates that the element of "additionality" in the outlay could not have been significant and at least some of the activities which were supported by the outlay would, in all probability, have been undertaken by the companies concerned in any case.

Ordinarily, industries which consume agricultural products or other local raw materials or human inputs could be expected to show a higher degree of initiative than others. However, the empirical support is weak for such a conclusion. The major contributions to activities supported by 35CC came from the textile industry (37%), chemical and chemical products industry (28.9%), cement industry (11.6%) and paper industry (5.6%).

REGIONAL SPREAD

Section 35CC programmes were implemented in villages spread over 13 States. However, the implementation was not evenly distributed. About 60% of the programmes involving 70% of the total expenditure were centered in the five States of Gujarat, Maharashtra, Uttar Pradesh, Andhra Pradesh and Karnataka. Among the States which received scant attention, the prominent ones were Assam, West Bengal, Bihar and Tamil Nadu.

PROGRAMME CONTENT

The approved programmes covered a wide spectrum of activities and included schemes relating to self-employment generation, provision of medical and educational facilities, infrastructure such as roads and drainage, drinking water projects, rural electrification, housing, minor irrigation; supply of seeds, the distribution of fertilisers and pesticides to small and marginal farmers; supply of farm equipment and facilities for its repair and maintenance; and animal husbandry and technical assistance in developing cottage industries. Many of the approved programmes were of a mixed nature touching different aspects of rural welfare and development. This indicated a general desire on the part of the sponsors to benefit the selected area in a comprehensive manner in tune with the approach of the Government administered Integrated Rural Development Programme (IRDP). Among the single-category programmes, the more popular were the projects for: setting up of educational and vocational centres; rural electrification; setting up of dispensaries and medical centres, etc.; assistance in setting up rural industries; and, animal husbandry. Twenty-five percent of the total financial outlay on approved programmes went for creation of fixed assets like buildings, plant and machinery (including mobile medical vans), furniture, etc. Buildings accounted for 74% of the expenditure on fixed assets. It was also not surprising that the choice of the programme and its location was generally guided by corporate enlightened business interest or sentimental affinity of persons in control of the sponsoring company to certain areas. A well known pilgrim centre attracted a sizeable outlay (3.3 million Rs.) from companies belonging to a particular large industrial house.

UNDERLYING PURPOSE OF THE INCENTIVE AND HOW ACHIEVED

In 1976, well before the enactment of Section 35CC, the Union Minister of Agriculture and Irrigation emphasized the need for industry to help develop appropriate technology and transfer of necessary skills for the benefit of small farmers. However, this concept was not strictly followed in defining the "programme of rural development" for purposes of Section 35CC on its enactment in 1977. The definition was made much wider to include any programme for promoting the social and economic welfare of, or uplift of, the public in any rural area. Thus, the definition rested on two concepts; welfare (relief of distress) and uplift (eradication of poverty). The illustrative list of programmes for rural development to be considered for approval by the prescribed authority (Appendix I) included many categories of programmes with more "welfare" than "uplift" content, e.g., establishment and running of dispensaries, maternity, child and family welfare centres; nutrition programmes for school children; construction and maintenance of village streets, pavements and drainage; construction and maintenance of drinking water projects, such as ground wells and tubewells, etc.; cleaning of wells and ponds; and, assistance to weaker sections in constructing houses and sites provided by Government and village councils, etc. Thus, a large portion of funds made available under Section 35CC went towards welfare programmes involving little transfer of skills.

On it becoming clear that there was going to be no large-scale direct involvement of the corporate sector in rural development, it was emphasized that it was not so much the financial expenditure of the companies which was important, but efforts had to be made to have managerial inputs and expertise of the companies in management of rural development projects. Speaking in November 1980, Dr. M.S. Swaminathan, Member of the India Government Planning Commission, said:

> On an overall approach, what we call rural development has three major aspects: the minimum needs programme, the rural infrastructural programme and the employment generation programme. Business houses and industrial houses can also play a role in the minimum needs programme like drinking water supply, rural health care and sanitation, elementary education

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and a wide variety of other ancillary programmes put under the minimum needs programme. They can also play a part in terms of infrastructure in certain cases. But, I think business houses should concentrate on this single purpose . . . how do we really increase the family income in rural areas? If one can have that as a single major target instead of getting diversified, if one can have a single focus and thrust instead of chasing too many butterflies at the same time, one can also measure what impact that contribution has made. Putting an occasional drinking water well here or there is important. These are generally classified as philanthropic activities. The most important and the most meaningful contribution one could make is to increase the family income in rural areas so that the stigma that 48% of our people are below the poverty line could be removed as quickly as possible.

However, the above approach did not lead to a redrawing of the illustrative list of categories of programmes that could be approved for the purposes of Section 35CC. Section 35CC was amended in 1983 to provide that the prescribed authority could approve programmes only out of the classes or categories of programmes of rural development as might be specified by the Central Government in this behalf. However, the notification which specified such categories or classes of programmes (Appendix II) also included categories which Dr. Swaminathan would have considered as predominantly philanthropic or social in nature: construction and maintenance of drinking water projects; hospitals and dispensaries and family planning centres and rural link roads, village streets, pavements, drainage and sanitary latrines etc. Thus, the classes and categories of programmes which came to be approved under Section 35CC included many programmes which were essentially of a "welfare" nature and only a fraction of the very limited response to this incentive was used for its real purpose: the deployment of corporate skills of management and expertise for raising village family incomes.

REASONS FOR POOR INITIAL INTEREST AND DECLINING RESPONSE

Non-implementation by a significant number of companies of programmes which they had had approved by the prescribed authority indicates the inability or unwillingness on the part of many companies to tackle the managerial and other problems involved in executing a rural development programme on their own. This explains the lukewarm interest in this incentive on the part of the corporate sector, the virtual monopoly of the implemented programmes by the bigger companies and the preponderant role of the large industrial houses. Only they have the requisite administrative infrastructure to undertake obligations not immediately connected with the income-earning process.

Second, the Finance Act, 1978, inserted a new provision in the Act, Section 35CCA, to enable taxpayers to contribute to rural development. This provision allowed a company (along with other categories of taxpayers) to obtain full deduction in the computation of its taxable business profits, of the sum paid by it to an association or institution approved for the purpose of Section 35CCA and undertaking approved rural development programmes. Section 35CCA became operative from 1 June 1978. As could be expected, Section 35CCA became popular at the expense of Section 35CC. In fact, a number of companies after getting their programmes approved under Section 35CC, preferred to drop them and to make payments covered by Section 35CCA. It is, therefore, not surprising that as early as in November 1980, the Chief Commissioner of Income-tax, Bombay, reported that while 12 applications with proposed financial outlay of 14.6 million Rs. had been approved under Section 35CC, the number of applications approved under Section 35CCA was 66 involving an outlay of 47.5 million Rs.

The administration of Section 35CC does not seem to have posed any serious problem so far as the tax authorities were concerned. Litigations over interpretation of the statutory provision and audit objections for administrative lapses were few. The claims for deduction made by companies were generally allowed without much interference by the assessing officers. However, the approval of schemes involved considerable delay. The administrative procedures were time consuming. In several instances, neither the companies nor the revenue authorities appear to have appreciated all the implications of the statutory provision and complied with them fully.

Another deficiency of the measure was absence of an effective mechanism for monitoring the implementation of the approved schemes. While the prescribed authorities made welcome efforts to see that the assessees' claims for tax relief under Section 35CC did not suffer on legalistic or technical grounds, in none of the cases gone into in the course of the study was any independent monitoring or evaluation report found to have been available to the assessing officer to show whether the programme had been duly implemented according to the approved plan. Thus once a plan was approved, there was no effective check to ensure that the outlay incurred served to provide the benefits to the extent contemplated under the approved programme.

The experience of the operation of Section 35CC as revealed by the present study underlines the need for circumspection in providing incentives for achieving socio-economic objectives through the tax system. First of all, it is unrealistic to expect that taxpayers can be enthused to undertake philanthropic activities totally unrelated to their business merely because of some tax relief. Secondly, tax benefits tend to be appropriated largely by big resourceful taxpayers. Also, these tend to support activities which some taxpayer might have engaged in, anyway. Thirdly, the costs of a tax expenditure are unlikely to be commensurate with the benefits unless an effective mechanism for monitoring is also devised. Lastly, tax incentives do not seem to be the right vehicle for motivating private

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agencies engaged in business activity to take up philanthropic work on their own. The decline of Section 35CC with the introduction of Section 35CCA shows that donations to agencies specially set up to undertake philanthropic or rural welfare programmes are more popular than the idea of taking up such programmes directly. However, whether encouraging contributions for rural welfare indirectly through a tax incentive as embodied in Section 35CCA was an efficient method for promoting rural development is another matter not gone into. Evaluation of Section 35CCA was beyond the purview of this study.

It would be inappropriate to view the financial outlay made by an industry in implementation of programmes approved under Section 35CC (more than half thereof met by the Government as tax forgone) in isolation. There were other tax incentives for the industry to provide funds for rural development as such: Section 35CCA (payments to approved associations and institutions for carrying out approved rural development programmes); Section 80GGA(2)(b) (deduction in respect of donations for rural development); and, Section 80GGA(2)(d) (contributions to National Rural Development Fund). A large number of charitable funds and institutions participate in the work of improvement and advancement of poor rural people, donations which entitle the donor to tax relief under Section 80G of the Act. For an idea as to the total contributions made by the industry for rural development, outlays spurred by all these incentives have to be taken into account. The proper perspective to view Section 35CC would be to see it as a new instrument devised to involve industry directly in the cause of rural development. For various reasons, it failed to arouse much enthusiasm.

APPENDIX I

Illustrative list of categories of programmes for rural development to be considered for approval by the prescribed authority for purposes of Section 35CC

1. Assistance in the setting up of rural industries in selected areas by the rural poor to provide them self-employment.
2. (a) Establishment, and (b) running of dispensaries, maternity and child welfare centres and family welfare centres.
3. Nutrition programmes for school children.
4. (a) Establishment, and (b) running of educational and vocational training centres.
5. (a) Construction, and (b) maintenance of drinking water projects, such as wells, tubewells, etc., and cleaning of wells and ponds.
6. (a) Construction, and (b) maintenance of rural link roads, village streets, pavements, and drainage.
7. Rural electrification, i.e. provision of street lighting in village and electrification of Harijan/tribunal homes.
8. Assistance to the weaker sections in constructing houses on sites provided in rural areas by Government, village panchayats, etc.
9. Minor irrigation schemes, including the boring of tubewells and installation of pumping sets for the benefit of groups of small/marginal farmers.
10. Supply of improved varieties of seeds and provision of facilities for seed testing to groups of small/marginal farmers and assistance to such farmers for establishing seed farms.
11. Supply of fertilisers and insecticides to groups of small/marginal farmers and giving guidance and training to such farmers in the use of fertilisers, insecticides, etc.
12. Supply of plant protection equipment, sprayers, farm machinery, implements, etc., to the village panchayat for the use of groups of small/marginal farmers.
13. Animal husbandry – assisting farmers in cattle improvement through establishment of veterinary dispensaries, artificial insemination centres, dairy products processing, and marketing.
14. Assistance to groups of small/marginal farmers, landless labourers, etc., in poultry farming, horticulture, pisciculture, etc.
15. Establishment of workshops for servicing and repair of farm machinery and training of artisans, mechanics, etc.

APPENDIX II

Classes and categories of programmes of rural development specified by the Central Government for purposes of approval by prescribed authority under Section 35CC

1. Construction and maintenance of rural link roads, village streets, pavements, drainage and sanitary latrines.
2. Construction and maintenance of drinking water projects including installation of pump-sets, digging of wells, tubewells, and laying of pipes for supply of drinking water.
3. Construction and maintenance of hospitals, dispensaries, and family planning centres.
4. Development of community pastures or community forests on community land, that is to say, land belonging to Government or Gram Panchayat.
5. Construction of minor irrigation tanks, installation of pump-sets, as also digging and commissioning of irrigation tubewells for community use.
6. Establishment of veterinary dispensaries and artificial insemination centres.
7. Establishment and running of educational and vocational training centres.
8. Establishment and running of new and renewable sources of energy systems.

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Bibliography

Books

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

To facilitate ordering, a list of addresses of the main publishing houses is included on pages 46-48 of the January 1986 issue. Addresses of publishers which do not appear in this list are indicated in the item concerned.

AFRICA

Malawi

TAXATION IN MALAWI.
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Lusaka, Coopers & Lybrand, P.O. Box 30885, Permanent House Cairo Road, Lusaka, 1987. 15 pp.
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ASIA & THE PACIFIC

THE ASIA & PACIFIC REVIEW
8th Edition.
The Economic & Business Report.
Saffron Walden, World of Information, 1987. 254 pp., £ 25.
Annual report focusing current economic and business development issues and also including summary of 52 individual countries in the region.
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Joint Ventures between East and West

By Prof. Dr. Dennis Campbell

1. THE EAST-WEST TRADE CLIMATE

Although joint ventures between Eastern European and Western enterprises will be the focus of my remarks, it is important first to discuss the nature of East-West trade in general terms and in the context of the various forms which such transactions may take.

While, in the case of joint ventures, I limit my comments to the Eastern European countries – Poland, the German Democratic Republic, Bulgaria, Czechoslovakia, Hungary, Romania and Poland and their relationships with the West –, my examination of the general climate of East-West commerce and trade will encompass the Soviet Union as well.

In assessing the East-West trade climate, we must bear in mind that, for all that the partners may wish to pursue commercial interchange, and for all the economic advantage that such interchange may bring them, the realization of such commerce will be tempered in each case by two major factors:

(1) the political environment obtaining at that moment between East and West; and
(2) the ability of the partners to reconcile their requirements for hard-currency capital.

The United States and Soviet Union provide a useful example of the political factor and its impact on the trade relationship.

In the 1930s, more than 40 major American companies were involved in projects within the Soviet Union and more than 1,500 Americans were employed in the Soviet Union. In 1937, the United States accorded most favored nation status to the Soviet Union, creating a trading relationship without any restrictions.

But in 1949, the U.S. Congress passed the export control act which restricted the trade of 2,799 commodities. The Soviet Union lost its most favored nation status with the United States, and in 1951 the United States cancelled its trade agreement with the Soviet Union.

By 1969 the political pendulum was swinging the other way. The United States revised its export control list, removing 2,599 items and leaving only 200 restricted.

Within a few years, the United States and the Soviet Union had concluded 10 agreements greatly expanding the opportunities for trade between the two countries.

But the American restrictive mood re-asserted itself in 1974 in a new trade act that made more difficult commercial interchange between American enterprises and Soviet partners.

How effective were the American restrictions? Very effective as to American enterprises.

In 1983, the Soviet Union had approximately US$ 30 billion in hard currency imports. The United States share of that volume was less than 10%, less than US$ 3 billion – and 83% of that American share was grain exports.

Just as the first 20-year period of restrictions served primarily to create opportunities for Japanese and Western European enterprises to develop and expand their own East-oriented trade in the absence of their American competitors, so did the last round of American limitations bring new opportunities for Eastern trade to the Japanese and Western Europe.

By 1983, Western European partners accounted for 80% of the Soviet Union's trade with the West, with the Federal Republic of Germany being the Soviet Union's major Western trading partner.

While geographic proximity and historical linkage are major factors in this aspect of East-West trade, the voluntary withdrawal of the Americans from this arena between 1949-1969 and again in the late 1970s cannot be discounted.

My point is only that East-West commercial relationships are fragile and that profit and commercial advantage, the usual governing ingredients in any business venture, often must take second billing to political priorities and thus it is that potential trading partners – both East and West – often must approach a transaction with more caution than one would expect from a mere analysis of the economic and commercial factors apparent on the face of the matter.

The second "tempering" factor in East-West trade is currency. Most of the non-market economy nations have currencies either closely controlled by the government and denied participation as an international trading currency or – if such use is allowed – Western partners may consider the currency "soft" and not viable in commercial negotiations.

Let us look more closely at the economic and historical background of joint ventures between East and West.

II. JOINT VENTURES: ECONOMIC BACKGROUND

Between 1945 and 1967, there was no possibility for a

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Western investor to establish an enterprise with 100% foreign interest or a joint venture with mixed capital in an Eastern European country.

It is easy to suggest that the "cold war" – the political factor again – was the reason for this lack of opportunity. However, it was not the only reason.

The other reason results from the nature of economic management structures in socialist countries during that period. After 1945 and the widespread nationalization of economic resources in Eastern Europe – Yugoslavia being the exception – a strong, centrally-planned economic order was established.

During this period, the socialist states held a monopoly in the development and establishment of new economic units, new enterprises, and the nature and direction of investment and production available to existing enterprises.

At the same time, the socialist states attempted to develop among each other – through Comecon – a self-reliant, inward-looking trade regime that did not look to Western markets or investors.

By the 1960s, Hungary and Yugoslavia in particular began to look toward the West for technology, while at the same time Western enterprises sensed that the East offered important potential markets for its goods. At the outset, in fact, the main form of the commercial relations was the export and import of goods; later other forms of economic co-operation developed; long-term co-operation contracts, licensing, franchising, leasing contracts and coproduction agreements, for example.

The flow of capital increased as a more sophisticated commercial relationship was accepted and encouraged first in Yugoslavia in 1967, then in Hungary (1970-72) and Romania in 1971-72. The first Polish legislation on foreign capital in small enterprises appeared in 1976. Bulgaria, in 1980, published its foreign investment legislation. Some of these codes were modified in the late 1970s and the early 1980s and perhaps the most significant reforms took place in Hungary in 1982 and in Yugoslavia in 1984. The most important developments of the last two years were the Polish legislation in 1986 and the publication of the Soviet law on joint ventures with foreign participation.

Referring to these codes and other legislation, it is important to emphasize that the absence of legislation on joint ventures in other countries (the German Democratic Republic and Czechoslovakia) does not necessarily mean that in these countries there is no opportunity for establishing enterprises with joint capital. It means only that, if a foreign and a domestic company think to establish a joint venture in East Germany or Czechoslovakia, all questions of the investment must be decided individually, including any licensing procedures. This so-called system of "concession" is so complicated that, despite the theoretical possibility of foreign investment there is little joint venture activity with mixed capital in these countries. For example, in Czechoslovakia the first mixed company with Western capital participation was established at the end of 1986. The joint venture "Tessek" produces biotechnological equipment. The parent companies are Tesla of Czechoslovakia, with 51% participation, and Senetek of Denmark, with 49% participation.

The great number of socialist countries having a normative code and the relatively rapid development and improvement of this legislation suggests the advantage of joint ventures for the socialist states as an economic form in East-West trade. Summarizing briefly these advantages, the following can be mentioned:

(a) In all socialist countries there is a shortage of capital which has caused a significant cut-back in the field of investments. In the last two decades, many states tried to balance this shortage by raising credits on the Western capital-market which in turn has led to increasing indebtedness for these countries. The investment of foreign capital in joint ventures is a much more favorable source for the Eastern economy because the profitability of the business is the risk of the foreign partner.
(b) All the Eastern countries need modern technology. These economies are interested in importing intellectual property from the West to improve the marketability of their products because these products must be sold in the world market to enable the Eastern countries to pay their debts. To buy licenses and know-how is less favorable than to receive modern technology in the form of contributions to the assets of joint ventures.
(c) Foreign investors usually offer good business connections and distribution networks on the world market which help the export of the products of the joint venture in Western countries.
(d) In many cases, the foreign investor, having a well-known name and good reputation, contributes its trade mark to the joint venture, a further advantage for the Eastern partner.

III. NEW DEVELOPMENTS IN JOINT VENTURE LEGISLATION

As was mentioned above, in some countries legislation on joint ventures was modified in the 1970s and 1980s. Without exception, these modifications brought a more liberal atmosphere in joint venture laws, extended the possibilities for foreign investors, created increased advantages for foreign investors, and simplified the licensing procedures of joint ventures.

Significantly, the general economic situation of the Eastern European countries did not improve, but rather deteriorated during this period. A new element also appeared during this period: the increasingly strong competition for foreign capital. Compared to 1967 and 1972, when the first three joint venture codes were published, an increasing number of countries created their own foreign investment codes through which to pursue joint ventures: in addition to the European socialist countries came China, Cuba, Ethiopia and the countries of the developing world. This com-

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petition stimulated several socialist countries to recodify their laws on joint ventures to make their economic and legal systems more attractive for foreign investors.

The benefits offered by a recipient country, of course, can vary significantly. In general, the most attractive factors are a cheap labor force, relatively inexpensive production, and the potential consumer demand in the national market.

I wish now to summarize the most important changes and developments, on the basis of types of changes rather than on the basis of country to country, because this will give a more effective view of the trends in joint venture legislation.

1. Sphere of activity

The first step in the reform of socialist joint venture laws involved the extension of joint venture activity to the production sphere. The first codes usually offered opportunity for common investments only in the field of commercial activity and services. The Hungarian legislation (Decree 28 of 1972 of the Minister of Finance, amended in 1977, 1978 and 1982) was modified in 1977, allowing joint ventures for production. The reason behind this new regulation can be found in simple economics: production is much more attractive for foreign capital because the benefits of exporting capital can be much more effective, and there are more opportunities for receiving modern technology licenses and know-how. The codes published in the 1980s (Bulgarian, Yugoslavian, Soviet, Chinese) all provide the same opportunity. For example, Decree 535 on Economic Cooperation between Bulgarian Juridical Persons and Foreign Juridical and Physical Persons (published in March 1980) declares in Article 2 that "Economic co-operation between Bulgarian juridical persons and foreign juridical and physical persons is carried out in production, scientific technical, engineering, development, marketing and other kinds of activity in the area of industry, agriculture, construction, commerce, transport, services and tourism". The relevant Polish regulation gives a less detailed and rather general rule: "The companies may be established with the aim of conducting economic activities consisting of the manufacture of goods and of rendering services and their sale at home and abroad" (Chapter 1, Article 2, Paragraph 2, of the Joint Venture Law of 1986). Nor are there restrictions in the new Soviet Code of 1987 concerning the activities of joint ventures.

After ten years of practice in Hungary, the picture shows that foreign investors from very different branches of industry and services have decided to join their money with Hungarian companies. The Central European International Bank, City Bank and the Bank of Budapest, having been established in the last few years in Budapest, are good examples of joint ventures directly involved in finance.

2. The ratio of foreign participation

Initially, all legislation (Hungarian, Yugoslavian, Romanian) limited the foreign participation to 49% of the joint venture capital. Yugoslavia abolished this limitation in 1978.

The Bulgarian law now allows foreign majority, as well. The Hungarian regulations claim that the foreign participation in general cannot exceed the 49%. This "general" restriction means that in particular cases – such as in banking – the Minister of Finance is entitled to license the greater share of foreign capital. In Hungary, for example, in the Central European International Bank the Hungarian share is only 34%; but other examples can be mentioned from the field of production, too: such as Adidas in Budapest.

The same regulation is in force in Poland, where the Minister of Foreign Trade may, acting in agreement with the Minister concerned, depart from the general rule of 51% Polish majority "provided that state security considerations do not constitute an obstacle" (Article 8, Paragraph 2).

The third approach is found in the Romanian and Soviet solutions, where the 51% domestic majority is a general rule without any normative exemption.

3. Companies owned and operated exclusively by foreigners

This form is not typical in socialist countries. The purpose of joint venture legislation is to combine the capital of the domestic enterprises with foreign capital. However, again, the lack of normative regulations does not mean that, in an individual concession procedure, one could not get a license for operating a company with exclusive foreign ownership. I might mention, again, with Hungary as an example, there do exist exclusively foreign-owned companies established before World War II which were not nationalized in 1947-48 and which are still operated by their foreign owners, SKF and IBM. We also find in Poland a theoretical possibility of ownership in special economic zones. But the legal criteria is fairly narrow: this form is open for small-scale businesses only, carrying out their activity in hotel, restaurant and other consumption-related fields. Participants in this form can be Polish citizens with foreign domicile or other nationals with other Polish relationships. Nevertheless, the number of this kind of small investment was more than 600 in 1985.

4. The liberalization and simplification of licensing procedures

The licensing procedures of the first codes can be characterized as long and complicated, having a concessive rather than a normative character.

It is the Yugoslavian reform which provides the most efficient and most normative procedure. Article 45 of the Law on Investment of Resources of Foreign Per-

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sons in Domestic Organizations of Associated Labor prescribes that "the federal administrative agency overseeing activities in the areas of energy and industry must rule on the application requesting the approval of the investment contract within 60 days from receipt of the application". Before rendering its ruling, the federal agency obtains an opinion from the appropriate federal administrative agencies and other relevant authorities and organizations. Authorities and organizations must submit a reasoned opinion within 30 days; if they fail to do so in the prescribed time limit, their opinion will be deemed as favorable.

An appeal can be submitted against the ruling of the federal administrative agency, which rule shows the strong normative character of the Yugoslavian law. The registration of the joint ventures is made ex officio within 15 days from the date of the ruling on the request for the approval of the investment contract.

The Hungarian modification has not brought such dramatic and significant changes in the licensing procedure, but it has a great importance in that, instead of the three licenses previously required, a much easier and shorter procedure is followed. No license is required either for the preparatory or the real negotiations. When the parties have agreed upon the establishing of the joint venture, the Hungarian party must report it to the Ministry of Finance. This report must contain all relevant questions of the negotiations and the planned joint venture. The negotiations can go on without interruption, the Ministry making its remarks – if there are any – within 30 days. All documents and contracts by the parties must be submitted for approval to the Minister of Finance, who will make his decision after having got the opinion of the Intergovernmental Commission. After the approval, the joint venture must be registered in the court of register (Articles 3, 4, 5 of the Executive Order of 1979 of the Minister of Finance).

In Poland, the required permit is granted at the request of the Polish partners by the Ministers of Foreign Trade acting in agreement with the Minister of Finance and other authorities competent by virtue of separate legal provisions. The decision concerning the granting of a permit is issued within 3 months (Articles 5 and 9 of the above-mentioned Polish law).

In comparison to these simple, quick and normative licensing systems, the new Soviet law creates a rather complicated procedure: the joint venture contract must be submitted to the relevant ministry of the republic in question; this ministry submits the contract to the council of ministers of the republic, which, having received the opinion of the Soviet State's Planning Committee and Ministry of Finance and other ministries and authorities interested in the question, submits the case to the Council of Ministers of the Soviet Union, which is the relevant forum to approve the joint venture agreement.

5. Guarantees

By guarantees in joint venture law, I mean the legal guarantees given by State national banks against nationalization or other damages deriving from intervening State administrative action. All legislation has some rule on guarantees, offering different forms to this end. Roughly, there are three typical forms of guarantees – besides the different insurance contracts available also in Western countries. The first, which we find in the codes of the 1970s, is that the national bank extends a bank-guarantee on the request of the foreign party to make good all losses deriving from the State administrative actions (Article 11, Paragraph 2, of the Hungarian Law on Joint Ventures). The same solution is available in Bulgaria. The Bulgarian Foreign Trade Bank may guarantee the claim for compensation of the foreign partner for pecuniary damages resulting from acts of Bulgarian State authorities (Article 17 of the Bulgarian code). The Polish code makes a similar provision in its Article 24, Paragraph 6.

The second type of guarantee is a basic law specifying that foreign property enjoys a special protection against State actions. The Yugoslav Constitution says in its Article 27: "the rights of foreign persons to resources invested in an organization of associated labor in the Socialist Federal Republic of Yugoslavia may not be restricted by statute or another enactment after the contract from which this right-system has become valid".

The Soviet Law on Joint Ventures (1987) asserts explicitly that the assets of joint ventures cannot be seized or confiscated by administrative measures.

The third means in the field of guarantees are the bilateral investment protection treaties on the governmental level. Many treaties of this kind were made in the 1980s by Romania with France, Italy, Austria and West Germany, for example. Hungary, too, has made significant efforts in this field in the last years, with agreements with the Netherlands, Belgium, Luxembourg, West Germany, the United Kingdom and Italy. These treaties assure fair and equitable treatment of the foreign partner. They promise that no Contracting State will take any measures depriving directly or indirectly investors of the other contracting party of their investments unless the measures are taken in the public interest. The treaties usually stipulate for arbitral tribunals if disputes cannot be settled peacefully.

6. Tax allowances

It is a general phenomenon – with only a few exceptions – that, since the 1980s, joint ventures in socialist and developing countries enjoy a more favorable tax system than exclusively domestic companies. This is a new trend compared to the 1970s. The advantages can be briefly characterized as follows:

(a) Joint ventures pay income tax, the rate of which is fixed in percentage of net income. This rate ranges between 20 and 50%, which is in most cases lower than the income taxes imposed on domestic enterprises.

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Reinvested income usually enjoys substantial tax preferences or tax exemptions.
Some examples:
(i) the general income tax in Bulgaria is 30%: for reinvested capital it is 20% (Article 36);
(ii) In Hungary, the general rate of tax is 40%, but the reinvested capital – as in Poland – is exempt from taxation (Article 30 of the Polish Code; Article 10 of Hungarian Decree No. 47 of 1984 of the Council of Ministers on Companies' Taxation).

(b) Allowances are, in many cases, accompanied with some years of tax relief. For example, in the Soviet law and in the Polish code, companies in the first two years are exempted from paying tax. In Bulgaria, the Minister of Finance and the Minister of Foreign Trade may exempt from tax or may reduce the rate for a period of one year, but no longer than three years, from the beginning of business activity. In Hungary, the tax relief period is administered to channel foreign capital to those branches of industry to which the Government attaches highest priority. From the general 40% tax rate, there are certain exemptions. Joint ventures carrying out production or operating hotel businesses, provided that the invested joint capital exceeds in each case 25 million forints and that the foreign participation exceeds 30%, pay 20% tax in the first 5 years and 30% from the 6th year. From these joint ventures, those which carry on activity of importance for the Hungarian economy are tax-exempted in the first 5 years and pay 20% income tax from the 6th year (Article 10 of the order on taxation). These preferred fields of activity include electronics, production of vehicle component parts, agricultural and food-processing machinery and equipment, development of packaging techniques, production of pharmaceuticals, material-and energy-saving techniques, technological development and tourism.

7. Duty-free territories

The regulation and practice of special economic and customs-free zones are highly developed in the People's Republic of China, but Eastern Europe is behind the times in this field. Only Hungary has created a set of rules on customs-free territories in 1982 (Joint-Decree 62 of 1982 of the Ministers of Finance and Foreign Trade). The benefits of the legal status of joint ventures in customs-free territories are unquestionable. Such enterprises qualify as foreigners as to customs regulations, foreign-exchange rules and the application of statutory rules relating to foreign trade.

The following Hungarian rules are worth mentioning.

Since joint ventures in such zones are exempt from the Hungarian foreign-exchange law, they can keep their accounts in convertible currency wherever they want, they carry out their transactions in foreign currency, may draw loans both from inland and from abroad, and may freely dispose of their assets deposited in Hungary in freely convertible currencies.

They can purchase the forint amount needed for their operation from the Hungarian banking institution against convertible currency.

Joint ventures in customs-free territories are entitled by law to carry out foreign trade activity.

Their export and import businesses are exempt from customs duties with the exception that, if they sell products in Hungary, the buyer has to pay customs as if the products were produced abroad.

These joint ventures are not subject to Hungarian regulation of enterprise income, enterprise wages, price, or investments.

Despite all the advantages the regulations contain, only three customs-free associations have been established in Hungary thus far. A small number compared to the more than 70 joint ventures and another 100 in the licensing process.

CONCLUSION

This brief survey should suggest that there has been movement in Eastern Europe and the Soviet Union to make the climate for Western joint venturers and investors more attractive and more enticing.

It is a given fact that there is a market for Western goods among Eastern consumers, that there are advantages in coproduction, advantages of cost, advantages of distribution, advantages in the ability of the Eastern partner to reach third markets not directly available to the Western investor.

Given these incentives, one may hopefully – perhaps optimistically – conclude that an increasing rate of joint investments will themselves contribute to an improved and more stable political environment and that good businessmen, East and West, male and female, will continue to find ways to solve the problems of hard and soft currencies.

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Direct Taxes in East and West

By Dr. Herwig E. Haase

I. INTRODUCTION

This First East-West Tax Conference is being held at a time of striking changes. To begin with, in both East and West increasing emphasis is being placed on the need to develop new economic concepts that bring economic theory more into line with reality and also promote better understanding between managers and economists. One kind of research that deserves mention is the coordinated search for a new link between logical deductions on the one hand and potentially misleading empirical assumptions and propositions on the other hand. Thus, according to Professor Daniel Bell of Harvard University, an economic theory intended to promote "understanding" must meet the following requirement in particular:

"And, finally, economic theory must return to time (in the logical sense) and history (as empirical reality) in order to examine the complex new social contracts that have resulted from the expanded scope of economic and social activity and the new areas they cover."[1*]

Bell's statement is amazingly similar to a comment made by L. Albakin, the top-ranking professor of political economy at the Central Committee's Academy for Social Sciences of the Communist Party of the Soviet Union, who declares:

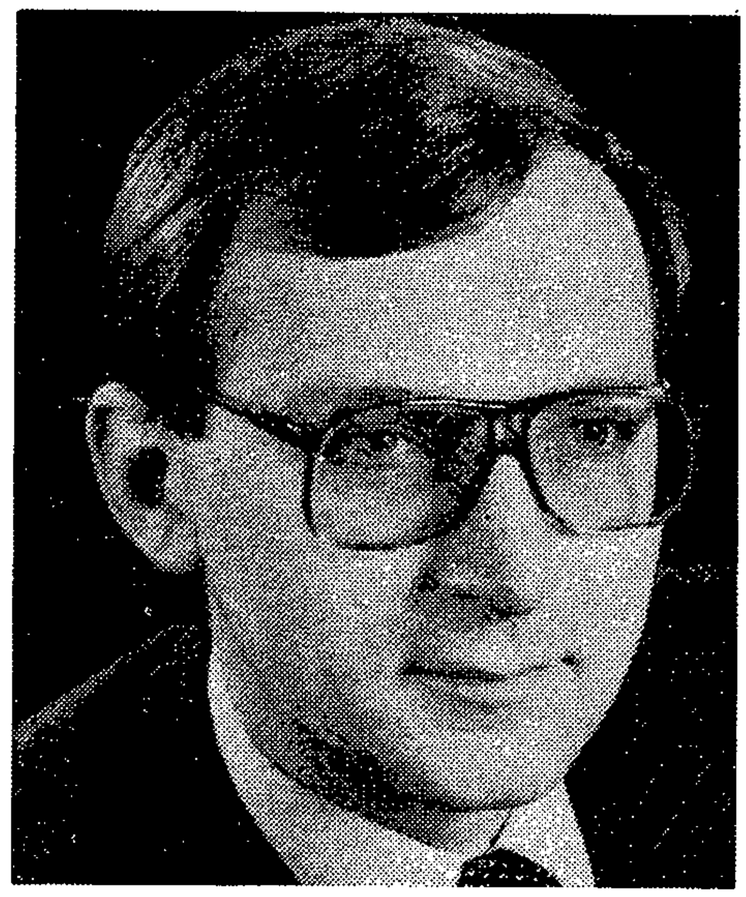
"Economic thinking can only be considered modern if it is strictly scientific and takes realities, the altered economic conditions, into account."[2]

In the second place, attempts are being made to revitalize East-West economic relations by increasing the number of joint ventures, which means that inter-systemary financial relations are growing in significance. Even though counter-purchasing and barter transactions – in other words, direct "goods for goods" exchanges – are becoming more common,[3] the changes being made in Eastern European economies[4] nevertheless seem to be directed towards overcoming stagnation. A policy of opening up markets is being recommended ever more frequently as a reaction to increasing Government intervention, so that the "era of experimentation"[5] called for by Eucken seems to be only in its initial stages.

Finally, many systems of taxation are undergoing radical changes that aim at distributing taxes more equitably by reducing the tax burden as well as by extending taxation of income. Not only the American "tax revolution", but also the introduction of a general income and value-added tax in Hungary represent striking milestones in the international development of taxes.

Even though the market for tax reforms apparently has its limits and *Buchanan*[6] in particular has pointed out that the scope for change is restricted due to the "quasi-constitutional nature" of the tax system, changes in taxation, including some that are revolutionary, have been announced or introduced in almost all countries. Last but not least, it should be noted that, in connection with discussion about the *Laffer Curve*, reductions in tax rates – such as the reduction for shipping companies in Ireland from 50% to 10% – have apparently become the rule, while increases – such as the increase of direct taxes in Nicaragua[7] – are now an exception.

However, tax law is still too complicated in the Western industrial nations. Considering the 5,000 tax laws and over 90,000 individual regulations that apply in the Federal Republic of Germany, it is not surprising that even at the German Tax Consultants' Conference it was stated that no tax consultant "can be acquainted with the whole of German tax law, let alone master it." (Tipke)[8]



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Thus it is clear that this paper can only discuss selected aspects of taxation in East and West. It will begin by presenting some theoretical generalizations about points of tax impact, the effects of taxation, and tax structures. The empirical analysis that follows will be based above all on data derived for the most part from OECD publications and publications of the International Bureau of Fiscal Documentation. This paper will conclude with some comments about tax questions in connection with East-West economic transactions. Such issues have not received much attention in research on public finance, even though a great deal has been published in this field as a whole.[9] One reason little has been written about such tax issues may be that there has been almost no exchange of experience between economists and managers in the past. Because there are so many special regulations, tax treatment in individual cases usually continues to be a well-guarded business secret. Furthermore, in the past tax questions have tended to be of secondary importance for East-West economic relations. Thus far it really is true that taxation requirements have never kept a contract from being concluded. In this respect legal analyses have been more common than economic ones when research is done concerning tax issues in East-West economic relations.

II. THEORETICAL ASPECTS OF TAXATION

1. Points of tax impact

The concept of the "revenue-expenditure process" (Musgrave[10]) is strongly influenced by the understanding of the economic system on which this process is based. Modern economies can be viewed as mixed economies in which at least three economic actors participate: the State and its organs, private households, and enterprises (in contrast to Government administrative units, the enterprises operate according to the principle of "economic accountability"). If we ignore borrowing as a source of funds, in a money economy private households finance their expenditures by means of income, the enterprises by sales revenues, and the Government by means of tax receipts and a negligible amount of income from fees and contributions.

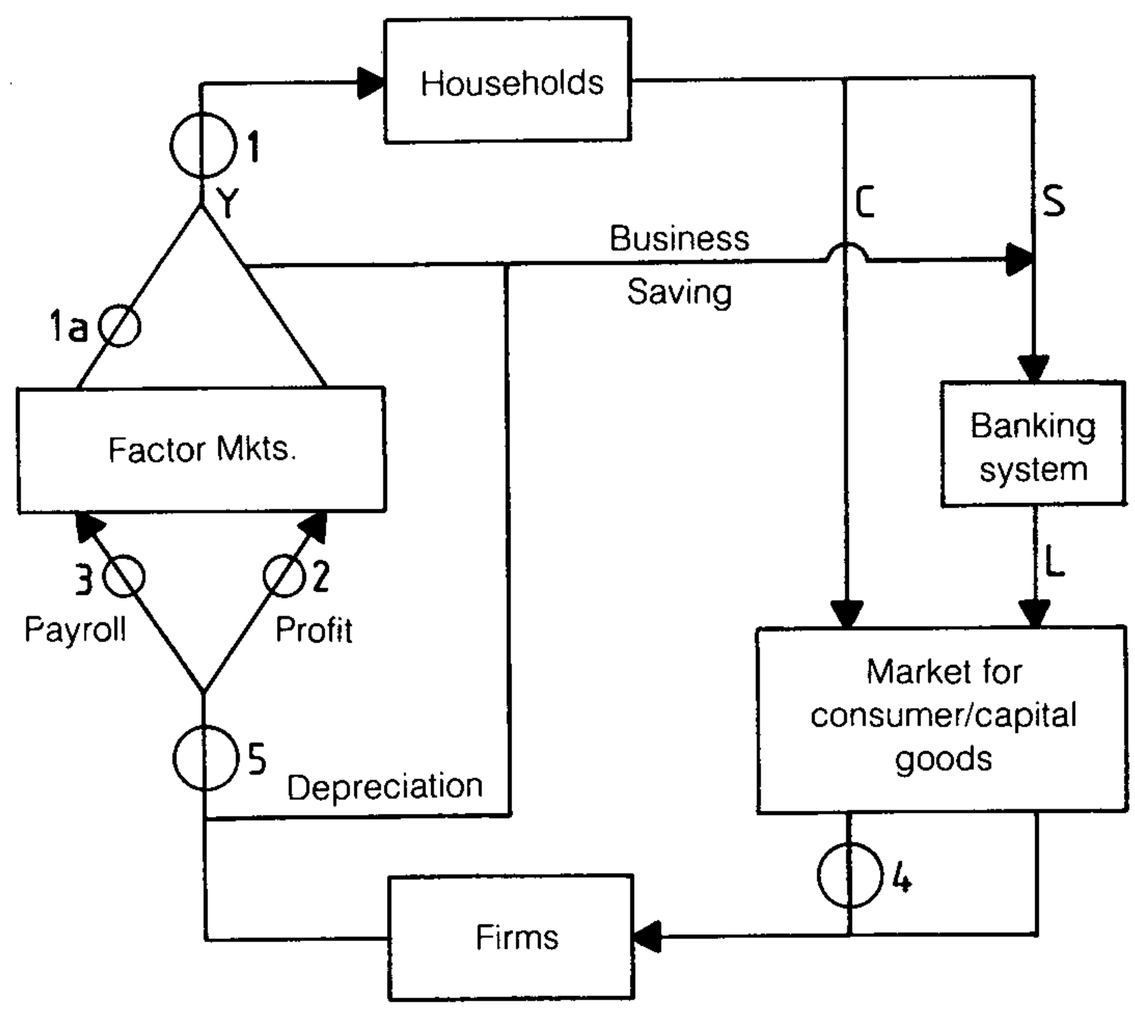
In this respect both market-oriented systems and centrally planned economies have a common feature, namely that they impose compulsory levies without providing any direct services to private individuals or enterprises in return. From an economic point of view, such levies constitute taxes, no matter what they are called in the respective system. Thus Article II of the CMEA "Multilateral treaty of 19 May 1978 for the avoidance of double taxation with respect to income and capital of legal entities" refers to "taxes, duties and other obligatory payments of a fiscal nature (hereinafter referred to as "taxes")".[11]

Thus the varying designations still in existence[12] really must be viewed as "a formality with little economic substance" (Musgrave[13]).

The situation is similar with regard to the points of tax impact, as can be illustrated by using a greatly simplified sketch depicting the circular flow of income and expenditure (cf. Figure 1)[14]. Private households use their income to finance consumption and – to a considerably smaller extent – for savings formation at credit institutions. Consumption expenditures flow into the market for consumer goods and thus become receipts for the enterprises that produce consumer goods. These firms then use the receipts to finance the depreciation of their fixed assets and to finance production costs, as well as to pay for production factors. Wages and profits or "bonuses" flow to the private households as income, which completes the circular flow.

The points of impact for the most important taxes can be designated as follows: The general income tax that dominates in most Western countries – which is substantially different from the wage tax of socialist countries (1a) – is levied at Point 1. Firms pay their profit taxes at Point 2, at Point 3 payroll and social security taxes are paid, and Point 5 is the point of impact for a tax on the net production value (e.g. Romania). If net worth taxes are included – also those on capital and labour – these taxes on income and earnings constitute the direct taxes to be discussed here, while the turnover and excise taxes levied at Point 4 represent the indirect taxes.[15]

Figure 1
Points of tax impact in circular flow



2. Functions

There is a large body of Western literature concerning the basic concepts of the theory of public finance, such as the equivalence or efficiency principle, criteria for and objectives of taxation.[16] One significant difference between Western and socialist theories of public fi-

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nance lies in the intensity of public discussion about tax issues. As far as the assessment of actual taxation practices is concerned, even though there is rarely public discussion of them in socialist countries, it seems possible to infer much of what transpired on the socialist side. The complexity of taxation in the West as opposed to the simplicity of taxation in Eastern Europe represents yet another contrast. Finally, there is a third difference: efforts to achieve more equitable taxation, for example by avoiding excess tax burdens and establishing an optimal tax structure,[17] cannot be identified in Eastern Europe.

Besides providing funds, taxes in East and West perform similar functions as far as allocation (including "stimulation" and control), distribution and stabilization are concerned. In this connection the objectives are: making social goods available (but not producing them), influencing income distribution (which is said to be more equitable in Eastern societies, though this point is sometimes disputed)[18],and promoting full employment, growth, and price stability.[19] However, it should be noted that such functions are subsidiary in centrally planned economies and intended to support a system of management and planning based primarily on balancing, quotas and norms.[20]

The effects of taxation can be illustrated by using a highly simplified textbook example (cf. Figure 2). Assuming that a private household wants to buy only two commodities and that its preferences are known, a general tax on income or on consumption reduces the consumption of both products. The point of equilibrium dropts from E_4 to E_3, where the lower utility function (U_3) touches the Budget line after tax collection (A'B'). Otherwise only an "income effect" occurs.

If, on the other hand, the same tax yield is to be achieved by imposing a selective excise tax on only one commodity, an avoidable excess burden is created to the following extent: now the new point of equilibrium E_2 created by the meeting of the income and the substitution effect is located on a lower utility curve (U_2) (cf. Figure 3). It should be pointed out that this theory includes very few findings which are adequately supported by evidence and therefore universally valid. Tax collection certainly does represent a burden, but on the other hand an additional burden does not necessarily have to result because, for example, the consumer takes gross price ratios and the producer takes net price ratios into account when making decisions.[21]

This theoretical model of taxation effects is interesting despite the lack of concrete evidence thus far. For one thing, as Jonas[22] has pointed out, such a model makes it possible to show the combined effects of taxation in systems where fixed prices are set by centralized authorities. Assuming that State planners intend to make only a certain amount of taxed (industrial) goods (OD) available, the point of equilibrium at E_2 indicates the presence of a considerable inflationary gap. This gap can be closed either by raising prices drastically or by introducing income taxes in addition to consumption (excise) taxes. Taking the latter approach could mean

Figure 2
The "income effect" of a general tax

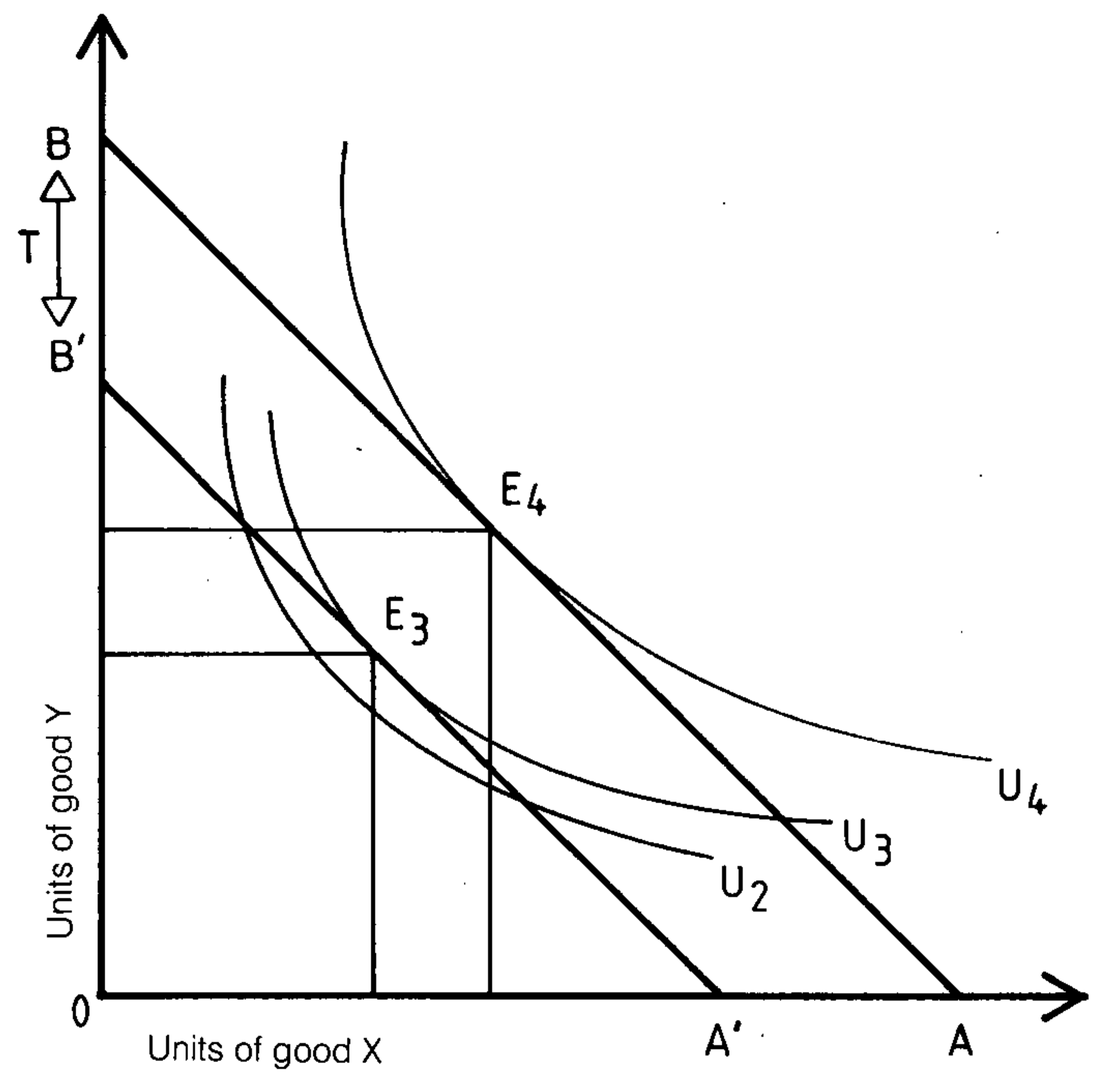
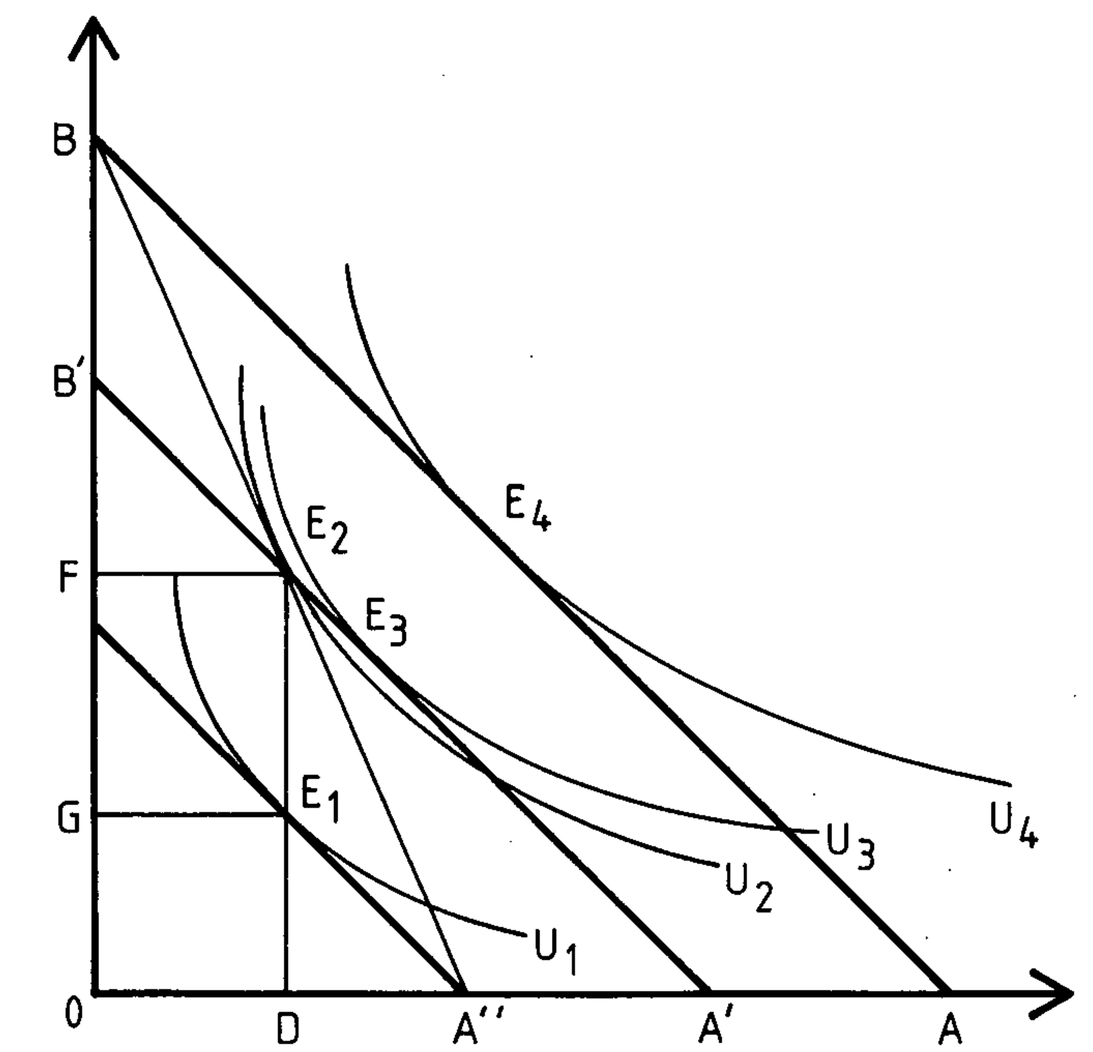


Figure 3
"Excess burden" and tax structure



that disposable income (OB) is reduced to the new level of real income (OF) by the total amount of taxes levied (BF). This could be achieved by levying an income tax (BB'), along with a special consumption tax producing the tax revenues shown at B'F. The tax rates necessary to achieve these results can also be

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calculated using a given amount of goods, given prices, and the utility index desired.

Finally, it is possible to generalize on the basis of this example, as well as on the basis of how point supply is known to function at the microeconomic level, that basing total tax revenues on a single tax is not advisable. Even though current consumption tax rates have not noticeably reduced surplus demand in Eastern European economies, drastically increasing these tax rates would endanger collection of the desired tax revenues. This is one of the more important reasons why all mixed economic systems are characterized by a mixed tax system, including a wide range of direct and indirect taxes.

However, in the final analysis taxes are always a burden – in both socialist and capitalist systems.

3. Direct taxes

In fiscal theory the definition of differences between direct and indirect taxes is quite controversial, is not customary in many centrally planned economies, and is treated inconsistently in both national and international statistics. This is surprising, because data about indirect taxes are of some significance for national accounting when national income is calculated on the basis of gross national product (GNP). There are discrepancies between the OECD classification employed here and the UN classification, particularly with regard to data about social security and payroll taxes (cf. Figure 4).

Figure 4
Comparison of the OECD classification of taxes with the system of national accounts (SNA)
OECD classification

	SNA*
1000 Taxes on income, profits and capital gains	Direct taxes
1100 Taxes on income, profits and capital gains of individuals	– on income
1110 On income and profits	– not elsewhere classified
1200 Corporate taxes on income, profits and capital gains	
1210 On income and profits	
1220 On capital gains	
1300 Unallocable as between 1100 and 1200	
2000 Social security contributions	Separate flow
2100 Employees	
2200 Employers	
2300 Self-employed or non-employed	
2400 Unallocable as between 2100, 2200 and 2300	
3000 Taxes on payroll and workforce	Other indirect taxes
4000 Taxes on property	
4100 Recurrent taxes on immovable property	Other indirect taxes
4110 Households	
4120 Other	
4200 Recurrent taxes on net wealth	Other direct taxes
4210 Individual	
4220 Corporate	
4300 Estate, inheritance and gift taxes	Separate flow: capital transfers not a tax
4310 Estate and inheritance taxes	
4320 Gift taxes	
4400 Taxes on financial and capital transactions	Other indirect taxes
4500 Other non-recurrent taxes in property	Separate flow: capital transfers
4510 On net wealth	
4520 Other non-recurrent	
4600 Other recurrent taxes on property	
5000 Taxes on goods and services	Indirect taxes
5200 Taxes on use of goods, or on permission to use goods or perform activities	Various
5210 Recurrent taxes	
5211 Paid by households in respect of motor vehicles	Other direct taxes
5212 Paid by others in respect of motor vehicles	Other direct taxes
5213 Other recurrent taxes	Other direct taxes (if paid by households) Other indirect taxes (if paid by others)
5220 Non-recurrent taxes	Separate flow
5300 Unallocable as between 5210 and 5220	
6000 Other taxes	Various

* "Direct taxes on income in SNA are those levied by public authorities at regular intervals, except social security contributions, on income from employment, property, entrepreneurship, capital gains or any other source of income. Direct taxes not elsewhere covered are levies by public authorities at regular intervals on the financial assets and the net, and total, worth of enterprises, private non-profit institutions and households; and on the possession, or use, of goods by individuals and households. Excluded are non-recurrent levies in respect of these items. Indirect taxes are those assessed on producers in respect of the production, sale, purchase or use of goods and services, which they charge to the expenses of production. Other criteria for dividing taxes into direct and indirect have been proposed but, apart from the clear cases of income taxes and consumption taxes, there is no general agreement on the appropriate classification of particular taxes. In view of this multiplicity of criteria and the difficulties in their application, the distinction between direct and indirect taxes has not been used here."

Source: OECD Revenue Statistics of OECD Member Countries 1965-1985, Paris 1986, at 49 ff.

For our purposes, direct taxes are defined as all levies paid by enterprises and individuals on their income, profits and property. In other words, only taxes on application of income are excluded. This conference paper will deal only with those taxes that are (or can be) regulated by international double taxation treaties. However, this is not equivalent to stating that income taxes are better than consumption taxes. The income tax has nevertheless been established as the most important direct tax levied in most countries, a fact that has been explained as follows by one of its most prominent proponents, Richard Goode:

> Income is better than consumption as a measure of ability to pay, and the reduction of income inequality is a more meaningful political objective of taxation than the lessening of consumption inequality.[23]

As for the rest, it should be pointed out that general

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taxation can still produce differing tax burdens. For example, this probably applies to agricultural income and profits in all industrial nations, and also to tax concessions made on the basis of regions or branches. For example, in Japan salaried workers have to pay taxes on at least 90% of their earnings, small business men about 60%, and farmers only about 40% of their income. In Germany the net transfer of direct taxes (including social security contributions and payments) at the average gross income level of 4-5000 DM per month covers only 11% of the income of business men, but 15% of civil servants, and 35% of workers and employees.[24] In this connection the distribution of taxes in Eastern European countries according to type of entity does not seem so unique that it deserves special mention. The tax incidence favours farmers in both systems, while there are tax incentives to be self-employed in the West and to be dependent in the East.

III. EMPIRICAL ANALYSIS OF THE TAXATION SYSTEMS

1. Tax-GDP ratios

The OECD[25] publishes comparative studies of developments and changes in the taxation systems of the Western industrial countries on a regular basis. With only a few exceptions,[26] comparable studies are lacking for the industrial nations of Eastern Europe. Since national statistics are based on differing concepts – as is evident in the international statistics (U.N., IBFD) – many simplifications and estimates are necessary to make such data comparable. Because of this situation, it would be advisable to set up a multinational research project in order to put comparative public finance on a solid statistical basis.

Since none of the East European countries except for Hungary publishes data about gross domestic product (GPD), it is necessary to begin by estimating their respective GDPs on the basis of World Bank data (see Table 1). Such an expanded data base is required because there are individuals and enterprises not included in net material product (NMP) statistics who also pay taxes. This applies to banks in Eastern Europe, for example. Tax rates for bank profits are highest in Bulgaria, while taxes on bank profits in the G.D.R. have displayed the greatest elasticity of tax revenue during the past years. If such an expanded data base (which, furthermore, has to be calculated in market prices) is not utilized, we arrive at a tax-GDP ratio amounting to more than 100% of NMP, as can be seen for the G.D.R. In economic terms, this means that not only has all income been distributed via the public budget – which has naturally not occurred in reality – but also that more was distributed than was originally produced.

TABLE 1

NET MATERIAL PRODUCT, GROSS DOMESTIC PRODUCT, AND REVENUES IN EASTERN EUROPE
(BILLIONS OF NATIONAL CURRENCY OR PERCENTAGE)

Indicator	Bulgaria lev	C.S.S.R. crown	G.D.R. mark	Poland zloty	Romania ley	Hungary forint	U.S.S.R. ruble
Net material product (NMP)							
1980	20.5	486.3	187.1	2,236.1	508.7	582.9	462.2
1985	25.0	560.0	233.6	9,156.7	760.8	842.3	577.7
1980 = 100[1]		115		409	148	945	125
	(120)	(109)	(124)	(96)	(124)	(107)	(119)
Gross domestic product (GDP)							
1980[2]	28.1	569.6	219	2,495.2	619.9	721.0	589.5
1985[3]	31	683	341	11,170	916	1,034	705
1980 = 100	109	120	156	447	148	143	120
1980: NE '80(=100)	137	117	117	112	122	124	128
Revenues (rev.)							
1980	13.3	306.3	160.7	1,220.2	298.0	447.5	302.7
1985	18.0	359.7	235.5	4,043.5	300.1	593.5	390.6
1980 = 100	135	117	147	331	101	133	129
Revenues as percentage of							
NMP (=100) 1980	65	63	86	55	59	77	65
1985	72	64	101	44	40	70	68
GDP (=100) 1980	47	54	73	49	48	62	51
1985	59	53	69	36	33	57	55

Notes: 1. ( ): comparable prices.
2. World Bank.
3. Estimated using the average GDP:NMP coefficient of 1.22 (1980) for the 1985 NMP data. *GDR* figures include a price-increase rate of 20%. *Hungary:* official figures.

Sources: Statistical yearbooks of the individual countries.
1986 Statistical yearbook of the Member countries of the Council for Mutual Economic Assistance, at 39, 54 f. (in Russian).
World Bank Staff Working Papers (Nos. 771-777), Washington 1985.

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TABLE 2

1985 TAX REVENUES IN EASTERN EUROPE
(BILLIONS OF NATIONAL CURRENCY OR PERCENTAGE ( ))

Revenues[1]	Bulgaria	C.S.S.R.	G.D.R.	Poland	Romania	Hungary	U.S.S.R.
National Budget	18.0	359.7	235.5 (100)	4,043.4 (100)	300.1 (100)	593.5 (100)	390.6 (100)
Turnover tax	n.a.	82.1 (22.8)	46.0 (19.5)	1,307.5 (32.3)	93.7 (31.2)	92.2 (15.5)	97.7 (25.0)
Income tax		47.4 (13.2)	17.2 (7.3)	70.4 (1.7)	4.3 (1.4)	22.0 (3.7)	33.9 (8.7)
Social security		5.1 (1.4)	17.3 (7.4)	381.2 (9.4)	40.0 (13.3)	135.3 (22.8)	25.4 (6.5)
Corporate taxes			54.9 (23.3)	1,058.7 (26.2)			
Taxes on property		180.5 (50.2)	28.8 (12.1)	234.9 (5.8)	113.3 (37.8)	286.7 (48.3)	119.5 (30.6)
Payroll tax			26.6 (11.3)	525.8 (13.0)	45.0 (15.0)		
Other revenues		44.6 (12.4)	44.7 (19.0)	464.9 (11.6)	3.8 (1.3)	57.3 (9.7)	114.1 (29.2)
Tax yield (90% of the national Budget)[2]	16	323	206[3]	3,639	300	534	351
Direct taxes (in % of tax revenue)	12 (75)	241 (75)	160 (78)	2,331 (64)	207 (69)	442 (83)	253 (72)
Tax rate of GDP	52	47	60	33	33	52	50
Direct taxes in % of GDP	39	35	47	21	3	43	36

Remarks: 1. Estimated using the U.N. scheme as far as the national tax statistics do not allow more detailed breakdown. For example, the "income taxes" of the GDR contain the tax revenue of private and co-operative craftsmen and trading, additionally to wage taxes.
2. Without Romania.
3. Estimated in consideration of ascertained double counting to an amount of 6.6 billion marks.

Sources: Statistical yearbooks of the countries concerned. *United Nations* (ed.): Statistical Yearbook 1983/84, New York 1986, at 259. See Table 1 (GDP).

TABLE 3

TAX REVENUE PER CAPITA IN US$

	Bulgaria	C.S.S.R.	G.D.R.	Poland	Romania	Hungary	U.S.S.R.
Gross domestic product							
Alton 1980	4,489	7,645	8,089	4,638	5,244	4,931	—
World Bank	(2,651)	4,500	6,800	2,199	4,432	4,373	5,316
Alton 1985	6,590	8,993	10,723	7,718	6,638	5,580	—
World Bank '80 x Alton growth rates	(2,740)	4,780	7,470	2,175	4,740	4,625	5,580
Tax revenue per capita 1985	1,425	2,250	4,480	720	1,565	2,405	2,790
Direct tax revenue per capita 1985	1,070	1,675	3,510	460	1,090	1,990	2,010

Sources: *Alton, Thad P. et al.:* Economic Growth in Eastern Europe, Occasional Papers (OP 65 and OP 90). New York 1981 (at 24) and 1986 (at 23). See Table 2 (direct taxes in % of GDP).

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TABLE 4

TAX LEVEL AND TAX STRUCTURE 1985

Country	GDP per capita[1] US$	Taxes %	Taxes US$	Tax structure (%) Income	Profit	Social	Payroll	Property	Goods
Sweden (S)	11,410	50.46	5,760	38	4	26	5	2	25
Denmark (DK)	10,575	48.02	5,079	50	5	4	0.5	4	35
Belgium (B)	7,880	46.73	3,682	35	6	32	—	2	25
Norway (N)	13,215	46.41	6,133	24	17	21	—	2	36
Netherlands (NL)	8,530	45.54	3,886	21	6	44	—	3	25
France (F)	8,920	45.49	4,057	13	4	44	2	4	29
Austria (A)	8,550	41.95	3,581	23	3	32	6	3	33
Luxembourg (L)	10,755	41.43	4,456	28	16	26	0.6	6	24
Italy (I)	6,145	41.17	2,530	26	10	34	—	3	26
Ireland (IRL)	4,985	39.48	1,968	31	3	15	3	4	45
Great Britain (GB)	7,495	38.51	2,886	27	11	18	1	12	30
Germany (D)	10,030	37.73	3,783	28	5	36	—	3	27
Finland (SF)	10,500	36.00	3,783	46	4	9	0.3	3	38
Greece (GR)	3,380	35.23	1,190	14	3	35	2	3	43
Canada (CDN)	13,635	33.72	4,598	34	9	13	—	10	33
Switzerland (CH)	14,000	32.18	4,505	36	6	32	—	8	19
Portugal (P)	1,905	31.97	609	24	24	26	2	2	44
Australia (AUS)	11,840	31.21	3,697	45	9	—	6	8	32
New Zealand (NZ)	7,150	31.04	2,222	56	9	—	—	7	27
U.S.A. (USA)	15,025	28.99	4,356	35	7	29	—	10	18
Spain (E)	4,190	28.39	1,190	23	5	41	—	4	26
Japan (J)	10,610	27.38	2,906	24	21	30	—	9	15
Turkey (TR)	1,020	14,43	147	44	11	6	—	6	34
OECD[2]	9,020	37.11	3,348	32	8	24	1	5	30
G.D.R. (DDR)	7,470	60	4,480	8	27	8	13	14	22
Bulgaria (BG)	2,740	52	1,425	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Hungary (H)	4,625	52	2,405	4	(54)	25	(n.a.)[3]	(n.a.)	17
U.S.S.R. (SU)	5,580	50	2,790	10	(34)	7	—	(n.a.)	28
C.S.S.R. (CS)	4,780	47	2,250	15	(56)	2	(n.a.)	(n.a.)	25
Poland (PL)	2,175	33	720	2	29	10	14	6	36
Romania (R)	4,740	30	1,425	1	(38)	13	15	(n.a.)	31
CMEA	4,590	48	2,214	7	40	11	7	3	27

Remarks: 1. Estimated using the tax rate as basis.
2. OECD: 1984.
3. (n.a.): not available, but contained in other (figures).

Sources: OECD (ed.): Revenue Statistics of OECD Countries 1965-1985, Paris 1986.
See Table 2 (tax yield and tax structure of CMEA) and 3 (GDP and taxes per capita).

In addition to this, estimating actual tax revenues is very difficult (cf. Table 2). In general, it can be assumed that double counting occurs frequently in socialist Budgets.[27] For lack of more accurate data, it was assumed here that approximately 90% of Government revenues come from taxes. Table 2 shows that direct taxes dominate in the socialist countries as well, and that by no means does the tax ratio differ for systemic reasons. However, at least it can be said that the tax-GDP ratio for the economy as a whole apparently is just as poor an indicator of Government influence on the economy as is the relationship between the individual tax types for characterizing a specific economic system.

Finally, it should be pointed out that converting national currencies into U.S. dollars is quite problematic.[28] Since the respective tax-GDP ratios were calculated on the basis of their structural shares, if GDP is calculated as being too small or too great on the basis of dollar exchange rates this affects calculations of tax revenues at the same time (cf. Table 3). However, the (unsolved) exchange rate problem is one of the bottlenecks involved in doing business with the East and transferring income and profit to the West.

Excluding turnover taxes, corporate and social security taxes represent the two main types of taxes (cf. Table 4). These are supplemented by the income tax which dominates in most Western countries, and in centrally planned economies by taxes on capital and payroll, which were first introduced in the 1960s and 1970s.

If we compare tax rates and their relation to the respective level of national wealth in Figure 5, it is possible

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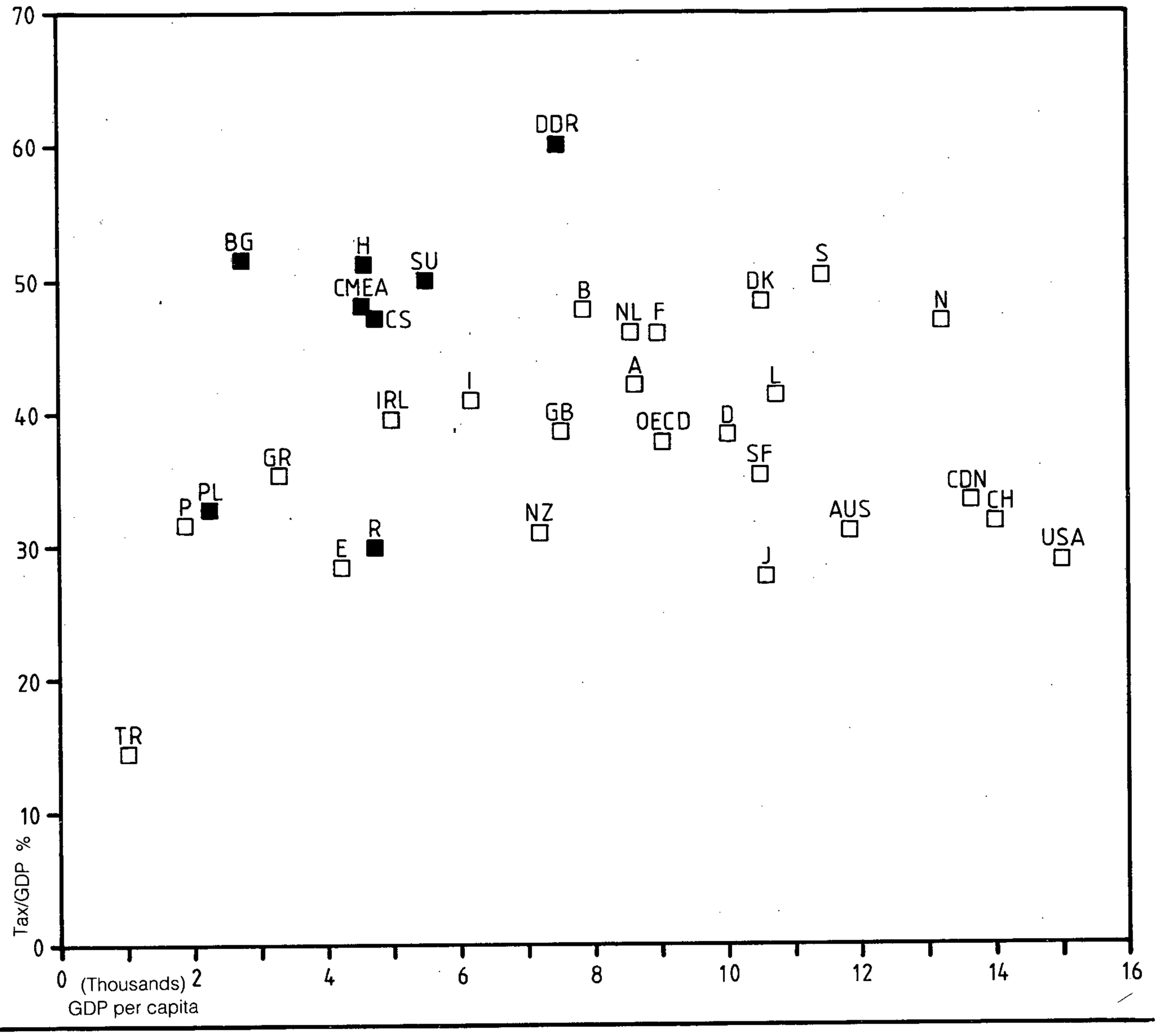
Figure 5
Tax rates and GDP per capita 1985



to develop three general theses: First, the relatively more prosperous countries have the relatively lowest tax rates at the same time. Second, tax rates in the East European countries are clearly higher, which is not surprising in view of their stronger influence on the financing of investments and social goods. Third, however, it becomes evident that tax rates are not only higher on the average, but that per capita tax rates are considerably higher in Eastern Europe at the same level of GDP. In this respect as well, Eastern European taxation deviates from the general trend.[29]

2. Income taxes

In centrally planned economies the tax burden on the income of private individuals varies depending on the source of income. This aspect of taxation varies greatly in the CMEA countries, ranging from elimination of wage taxation or maintaining it without taking wage reforms into account all the way to introduction of a universal income tax that includes income from the second economy. The East European countries have the lowest wage tax rates and the highest income tax rates. It is interesting to note that in Bulgaria, for example, more than 50% of average earned income is tax-exempt, while tax relief is provided in Czechoslovakia primarily by means of family taxation provisions. Finally, it appears that – also in Western countries – lower wage tax rates do not necessarily indicate a lower tax burden, though they probably do indicate the existence of lower income level (cf. Table 5).

Even though many firms in Western countries are subject to the general income tax (9 out of 10 in the Federal Republic of Germany), the corporation tax is considered to be the actual "corporation income tax" (cf. Table 6). As "income taxes levied on enterprises",

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TABLE 5

PERSONAL INCOME TAXES 1986

Country	Tax rates[1] Lowest %	Tax rates[1] Highest %	Average 1985: %	Basic relief US$	Highest rate at income of US$
Australia	30	60	21.9		
Austria	21	62	10.2	1,550	95,785
Belgium	0.3	76.3	24.8	2,200	88,070
Canada	8.88	50.3	19.4	2,850	45,435
Denmark	40.4	65.6	40.0	2,827	22,607
Finland	6	51	30.5		
France	5	65	7.4	2,209	34,115
Germany	22	56	18.1	2,034	58,310
Greece	12	63	3.2	744	34,685
Ireland	35	58	26.7	2,735	10,250
Italy	26.256	68.156	(17.4)	524	392,825
Japan	15.0	88	8.8	1,743	480,717
Luxembourg	12	57	16.7	2,853	30,755
Netherlands	16	72	11.0	2,927	91,045
New Zealand	20	66	27.9		
Norway	25	62	22.7	7,154	35,634
Spain	8	66	12.2	1,505	86,439
Sweden	34	80	35.6	1,094	49,219
Switzerland	5.86	42.44	11.2	5,506	228,668
Turkey	30	60	(25.6)		
United Kingdom	29	60	22.3	3,550	62,631
U.S.A.	13.6	58.8	22.8	1,090	88,270

							% of average working income	
Bulgaria	A_2	8	(24)	81	(96)	—	7	256
	B	0.08	(15.08)	14	(29)	(24)	53	149
C.S.S.R.	A	5	(7)	65	(85)	—	0	133
	B	5	(7.5)	20	(30)	(22)	0.7	83
G.D.R.	A	1.3		90	—	—	—	(4085)
	B	0.144		20		(19)	17	123
Hungary	A	2		75		—	(20)%	(1282)
	B	—		—		—	—	—
Poland	A	20		85		—	0	(200)
	B	—		—		—	—	—
Romania	A	6	(8)	75	(81.25)	—	0.9	295
(private)	B	3.2	(5.2)	45	(59.25)	—	32	—
U.S.S.R.	A	7.4	(13.4)	81	(87)	—	0	307
	B	0.35	(6.35)	13	(19)	(19)	37	53

Remarks: 1. Single taxpayer, including local taxes.
2. A: Income tax.
B: Wage tax (including the tax on childless persons, (i.e. for Bulgaria: 5, 10 ot 15%).
Average: Normative tax rate of a childless person with average income.

Sources: *OECD (ed.):* Personal Income Tax System Under Changing Economic Conditions, Paris 1986 (updated by: *Bundesministerium der Finanzen (ed.):* Die wichtigsten Steuern im internationalen Vergleich, Bonn 1986).
OECD (ed.): The Tax/Benefit Position of Production Workers 1981-1985, Paris 1986 *International Bureau of Fiscal Documentation (ed.):* Taxation in European Socialist Countries, Amsterdam 1986.
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taxes on the profits and capital gains of enterprises are closely linked to the modern income tax universally levied in Western countries. The changes being made in these taxes during the 1980s aim at reducing tax rates and simplifying definitions of the tax base, in good part because considerable differences exist between normative and actual tax burdens. Profit taxes have remained relatively stable in East European countries, although it should be noted that changes have been discussed in the Soviet Union and instituted in Hungary. Realistic comparisons of the tax burden in the different economic systems must not only take into account the varying utilization and significance of profits, but also the many possibilities for taking deductions (cf. Table 7). A similar situation seems to exist with regard to the taxation of income from capital investment. In this connection it is surprising to note that in some cases Western countries have higher special tax rates than do Eastern European nations (cf. Table 8).

TABLE 6

CORPORATE INCOME TAX RATES 1986

Country	Tax rates
Germany	56 (36)[1] (1990: 50)
Austria	55 (27.5)
Japan	52.263 (39.061) (1987: 37.5)
Sweden	52
U.S.A.	51.4 (1987: 34)
Norway	50.8
Canada	50
Denmark	50
Ireland	50
Greece	49
Portugal	47.2
Italy	46.368 (36)
Belgium	45 (1987: 43)
France	45
Netherlands	42
Luxembourg	40
United Kingdom	35
Spain	35
Switzerland	33.6
Bulgaria[2]	85
C.S.S.R.[3]	85 (75)
G.D.R.[4]	70 (95)
Hungary[5]	55
Poland[6]	60
Romania[7]	n.a.
U.S.S.R.[8]	58

Notes: 1. Distributed.
2. 8 proportional tax rates from 20 to 80%. Municipal tax: 3 or 5; Average profit tax: 58%.
3. 50 to 85%, usually 75%.
4. Estimated, 95%: Private firms.
5. 40% (foreign trade enterprises: 45%) + 15% municipal tax.
6. Income tax. Stabilization tax up to 40% of profits after income tax.
7. Net production value tax (Profits and Wages)
8. Average tax rate 1984.

Sources: See Table 5 (OECD and IBFD).

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3. Social security and property taxes

The dramatic increase in revenues from social security taxes in most Western countries is evidence that national social insurance programmes have expanded considerably. The trend toward the welfare State in both capitalist and socialist countries is illustrated by this development, with the socialist countries using primarily general revenues to cover their social expenditures. The tax ratios in Poland and Hungary are nevertheless strikingly high (cf. Table 9).

The same applies to the payroll tax. If we disregard the Soviet Union and Czechoslovakia, where this newest type of main tax has not (yet) been introduced, it can be seen that the exorbitantly high payroll tax rate in the G.D.R. aims at motivating enterprises to employ manpower more sparingly. An analysis of the intended effects could be illustrated in a manner analogous to Figure 3, with enterprise employment of the production factors capital and labour in connection with changes in factor price relations being explained on the basis of production theory. However, in this case success is by no means certain. For example, the reason given for eliminating taxes on capital during the 1970s was that, due to soft Budget constraints,[30] enterprises had by no means economized on capital investment in the manner intended. In addition, a more efficient combination of production factors represents an alternative to employing further direct and indirect regulatory instruments. Despite this, the introduction of further "fund levies" (on land and natural resources) is being discussed.

Otherwise the difference between property tax rates in the two systems is by no means what might be expected (cf. Table 10). Rather, they are higher in some Western countries although, because of the differences in determining the tax base, this does not necessarily mean the effective tax burden is higher.

4. Inter-systemary double taxation

In centrally planned economies, international agreements on double taxation are increasing in significance, even though their effectiveness is sharply limited by the foreign trade monopoly characteristic of this type of economic system. Along with economic interests, this explains why joint ventures as well as other economic activities receive more favourable tax treatment than public or private enterprises in East European countries (cf. Table 11). Such favourable tax treatment is granted either through specific tax regulations (in the Soviet Union), through tax laws regulating the private sector (in the G.D.R.), and/or by including taxation provisions in the respective joint venture contracts.

Usually the taxation of profits is regulated as follows: during the initial phase considerable exemptions from

TABLE 7

NORMATIVE AND AVERAGE TAXATION OF PROFITS IN WESTERN COUNTRIES

Country	Average (1983)	Normative (1984)	Normative (1986)
Germany	43	69.7	70.8
New Zealand	42	—	—
Japan	36	60.3	65.3
Austria	31	62.0	73.5
Finland	21	—	—
United Kingdom	20	45.0	35.0
U.S.A.	19	53.9	55.8
Canada	17	—	—
Belgium	17	—	—
Netherlands	16	48.0	42.0
Spain	16	—	—
Ireland	4	—	—
France	—	64.0	62.9
Sweden	—	52.4	58.0
Switzerland	—	39.0	37.6
Italy	—	—	46.4

* Corporate taxation, including general deductions for depreciation and investments.

Sources: *Fischer, Lutz:* Die Steuerbelastung der deutschen Unternehmen im internationalen Vergleich, in: Wirtschaftsdienst (Hamburg), 1985, Heft 1, at 33-41.
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Fuest, Winfried, and Rolf Kroker: Irrtümer in der aktuellen Steuerdiskussion, Cologne 1987, at 26.

TABLE 8

SPECIAL TAX RATES ON FOREIGNERS' CAPITAL INCOME 1986

Country	Dividends	Interest	Royalties
Austria	20	—	
Belgium	25	25	
Canada	25	25	
Denmark	25	—	
France	25	25	
Germany	25	—	
Greece	45	56.35	
Ireland	—	35	
Italy	32.4	21.6/25	
Japan	20	20	
Luxembourg	15	—	
Netherlands	25	—	
Norway	30	—	
Portugal	13.8	13.8	
Spain	18	18	
Sweden	30	—	
Switzerland	35	35	
United Kingdom	—	29	
U.S.A.	30	—	
Bulgaria	—	—	—
C.S.S.R.	25	25	30
G.D.R.	15	15	25
Hungary	—	—	20
Poland	—	30	30
Romania	10	15	20
U.S.S.R.	—	5	5

Source: See Table 5.

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TABLE 9

TAXES ON PAYROLL AND SOCIAL SECURITY CONTRIBUTIONS IN EASTERN EUROPE

Country	Tax rates	
	Payroll*	Social security
Bulgaria	—[1]	30
C.S.S.R.	—	20[2]
G.D.R.	70	12.5 (10)[3]
Hungary	10-50[4]	40
Poland	20[5]	43
Romania[6]	14.5-17.5	15
U.S.S.R.	—	9-4.4[7]

* In western countries there are only payroll taxes in France (18%), Luxembourg, Austria and Sweden (2%).

Notes: 1. Since 1984 the enterprise may have to pay a penalty rate for salary increases and/or for each new employee (i.e. 50 leva per month) out of their after-tax profits.
2. There is a lower rate of 10% for some organizations, i.e. computer centres.
3. Employees share, up to 60 marks per month.
4. Since 1985 the enterprises are subject to a wage-level, – increase or regulated wage system –, surplus and payroll tax (10%).
5. Since 1982 the enterprises may have to pay a progressive tax on salary increases into the "State fund for activation of the workers" out of their after-tax profits.
6. The payroll is part of the "net production value" tax.
7. The rates for coal industry respective farm sales workers.

Source: International Bureau of Fiscal Documentation (ed.): Taxation in European Socialist Countries, Amsterdam 1986.

TABLE 10

PROPERTY TAX RATES 1986 (in %)

Country	Private	Firms
Austria	1	1
Denmark	2.2	—
France	0.5/1/1.5	—
Germany	0.5	0.6
Luxembourg	0.5	0.5
Netherlands	0.8	—
Norway	1.2-2.3	0.5
Spain	0.2-2.0	—
Sweden	1.5/2/2.5/3	—
Switzerland	0.1-0.7	0.4
Bulgaria	0.2/0.3	0.2 (1965-1970: 3; 1971/72: 6)[1]
C.S.S.R.	(house tax)	(1972-1982)[1]
G.D.R.	0.5-2.5	6[1]
Hungary	(house taxes)	1985: 3 (1964-1978: 5)[1]
Poland	Urban property tax	3 (abolished: 5)[1]
Romania	(land tax)	(1975: abolished)[1]
U.S.S.R.	0.5/1	6[1]

1 Tax on fixed assets, payable out of profit.

Source: See Table 6.

tax liability ("tax holidays") are granted. Reserved profits, i.e. profits channeled into the respective reserve funds, are tax exempt, reinvested profits receive favourable tax treatment, and transferred profits are subject to a surtax. Any social security taxes are levied only on indigenous workers. On the whole, the tax problems in the commercial domiciles of the Western partners seem to be more complicated than in the countries where the mixed enterprises operate. But there is still obvious interest in such projects, [31] although it should be noted that the competitiveness of the taxation systems – and therefore tax law regulations as well – are probably of only marginal significance. Nevertheless, it would be interesting to know the extent to which the taxation experience of Eastern firms in the West has influenced tax legislation in the East.

It is possible to draw the following conclusions based on the comparison of tax burdens in Germany presented in the last table (cf. Table 12): in the first place, the West German tax burden – which other comparisons also assume is heavy[32] – turns out to be relatively light compared to the confiscatory tax burden in the East (and here it can be seen clearly why the example chosen is only fictitious and not real). In the second place, a Western firm operating in the East has a tax burden comparable to that borne by Eastern European State enterprises, which probably should be interpreted as simply an offer for tax negotiations when a contract is concluded. Finally, the comparison of income taxation shows that an employee in the West (whose pay is triple the average monthly pay in the G.D.R.) pays higher social insurance contributions, which are felt to be a more acceptable kind of tax. By contrast, the tax burden in Eastern Europe is also clearly heavier for a Westerner working there.[33] However, these observations based on simple calculations are more of theoretical interest than of practical relevance.

IV. DEVELOPMENTAL TENDENCIES

The development of direct taxation in the East and in the West shows that in many Western countries tax reduction and tax simplification programmes are used as priority measures to fight tax evasion and the second economy.[34] This is certainly a major step towards improving the competitiveness of Western economies.[35] However, such changes are not always beneficial for enterprises, as the American example shows.

The fiscal promotion of private economy and international activity can be found in centrally planned economies as well, while new taxes with allocative aims are being introduced for public enterprises. But there nevertheless seems to be a continued common interest in tax reforms. For systemic reasons, however, a harmonization of the tax systems of the European Community's (EC)[36] Member States seems to be much more urgent than for those of the Council for Mutual Economic Assistance (CMEA).

Finally it should be said that the development of an

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international, comparative theory of public finance is not only necessary, but is also possible at the same time. This paper's presentation of theoretical fundamentals, concepts, and statistical evidence in standardized form represents a small step in this direction. Of central importance, however, is the continued exchange of experience between those involved with the theory and practice of taxation in East and West, an exchange to which this first East-West Tax Conference has made a significant contribution.

TABLE 11

TAXATION OF FOREIGN REPRESENTATIVES AND JOINT VENTURES IN EASTERN EUROPE 1986

Country	Representatives	Joint ventures		
		Tax rates	No.	Bilateral tax treaties
Bulgaria	45 (1986)	20[1] (1980)	10	6
C.S.S.R.	60[2] (1981)	50 (1986)	2	18
G.D.R.	(60)[3] —	—	—	5
Hungary	40[4] (1984)	20/30/40 (1986)[4]	70	21
Poland	65 (1984)	50[5] (1982)	(1)	24
Romania	60 (1954)	30 (1972)	—	31
U.S.S.R.	40 (1978)	30[6] (1987)	—	13

Notes: 1. Additional tax on transferred profits: 10%, first three years tax-free.
2. 20% for small taxable profits. Minimum tax: 30% of the employees' gross salaries.
3. Lump-sum taxation.
4. Other taxes, especially on social insurance (40%); Hungarian employees only.
5. Reduced by 0.4% for every 1% of gross revenue derived from export. "Tax holidays" for two years.
6. Additional tax on transferred profits: 20%. "Tax holidays" for two years.

Sources: *International Bureau of Fiscal Documentation (ed.):* Taxation in European Socialist Countries, Amsterdam 1986.
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TABLE 12

CALCULATING EXAMPLE OF TAXATION IN GERMANY

A: TAXATION OF PROFITS

Assumption: profits before tax : 100 million M/DM
working assets : 500 million M/DM
rate of assessment (professional tax) : 400%

Western firms		*Eastern firm* (private)	
Profits	100.00	Profits	100.00
– trading capital tax (0.2%)	4.00	– trading capital tax (0.2%)	4.00
– business profits tax (5%)	16.00	– business profits tax (5%)	20.00
= income liable to pay corporation tax	80.00	= income liable to pay corporation tax	76.00
– tax on property (0.6% out of 75%)	2.25	– tax on property (2.5% out of 90%)	11.25
– corporation tax (56%)	44.80	– corporation tax (95%)	72.20
= usable owned capital (if fully accumulated)	32.95	= usable owned capital	– 7.45
Taxation	67.05%	Taxation	107.45%

Eastern firm (State-owned)		*Western firm in the East*	
("gross") profits	100.00	Profits	100.00
– capital tax (6%) ("production funds levy")	30.00	– business profits tax (5%)	20.00
= ("net") profits	70.00	= income liable to pay corporation tax	80.00
– tax on profits (70%) ("net profit payment")	49.00	– tax on property (2.5% out of 90%)	11.25
		– corporation tax (60%)	48.00
= usable profits	21.00	= usable owned capital	20.75
Taxation	79.00%	Taxation	79.25%

B: TAXATION OF INCOMES

Assumption: 3,000 M/DM per month
married wage earner, 2 children

	West		East		West	East
	table	effective (OECD)	table	effective	in East effective	in West effective
gross income	100	100	100	100	100	100
– income tax	12.3	10.9	19.0	12.0	20	10.9
– social insurance	17.0	17.0	10.0	10.0	—	—
+ children's allowance	4.8	4.8	1.3	1.3	—	—
= net income	75.5	76.9	72.3	79.3	80	89.1

* 1,500 M: tax rate = 5% = 75 M
1,500 M: tax rate = 19% = 285 M

Sources: The calculating example is based upon the tax legislation and on:
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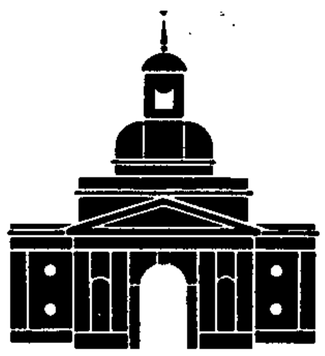

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THE NETHERLANDS:

Taxation of Eastern European-Source Income

By D. Hund*

INTRODUCTION

First, I would like to give you some general information on the Dutch tax system. Secondly I will make some remarks on the Netherlands tax treaty network. Then I will discuss the specific fiscal relations between the Netherlands and Eastern European countries as laid down in a number of tax treaties and, finally, I will look into the role the Netherlands can play as a departure point, or an intermediary for business transactions between third countries and Eastern European countries, as well as the function the Cyprus connection can have for Netherlands enterprises, doing business in Eastern Europe.

I. BASICS OF DUTCH TAXATION

Concept of taxable income

A resident taxpayer of the Netherlands, whether he is an individual or a company, is taxed on his world-wide income, wherever it arises. No distinction is made as to the source of the income, be it domestic or abroad. Nor is there any differential treatment between the foreign countries where the income might arise. To conclude: Eastern European-source income is not taxed differently from other income.

Tax rates

Individual income is progressively taxed. Tax rates go up to 72%, for taxable income amounting to more than approximately 240,000 Dfl.; the corporate tax rate is 42%. The Netherlands uses the classical system. The effective tax burden will be lower because of the "WIR", a credit against tax of 12.5% of qualified investments. Furthermore there is no capital tax on companies, nor local income taxes.

Residence

Under Dutch law, residency is based upon the circumstances. This basic rule applies both to individuals and to companies. What the relevant circumstances are is not defined in domestic legislation, so the concept has been developed under case law.

For individuals a great number of particular circumstances have been taken into account in determining residency: habitual abode, place where family lives, place where children go to school, church membership, participation in social life, and many other criteria. For companies, important circumstances are: location of the head office, place where the board meets; location of the general meeting of shareholders; place where accounts are kept, etc. Furthermore, a company is legally considered to be a Dutch resident if it is established according to Dutch law.

Company

"Company" includes a corporation ("N.V." or "B.V."),[1] or the foreign equivalent, but not a partnership. The individual partners are separately taxed for their share in the partnership. Whether a foreign entity qualifies as a corporation for Dutch tax purposes is determined by comparison.

Avoidance of double taxation

Unlike many countries, the basic instrument employed by the Netherlands for preventing international double taxation is exemption. This method is used under tax treaties, irrespective of the level of foreign taxes, and even if the foreign country concerned grants temporary or more permanent tax relief. If there is no tax treaty with the country concerned, the unilateral regulations for the avoidance of double taxation apply, which require that the foreign income be subject to tax in the country concerned to qualify for Dutch double taxation relief.

Whether tax has actually been levied is not relevant. For corporations, because of the flat corporation tax rate of 42%, exemption really means full exemption. For individual taxpayers, the foreign-source income is taken into account in determining the applicable tax rate on the other income ("exemption with progression").

The exemption method applies mainly to profits derived from a foreign permanent establishment or fixed base, income from an employment exercised abroad, and income from immovable property situated abroad. What constitutes a permanent establishment is not defined under Dutch law. Only the "Unilateral regulations" give some indication, and refer to a building site constituting a permanent establishment after twelve months. Case law has accepted to a large extent the OECD Model Article 5 definition of permanent establishment. Tax treaties usually contain a pretty elaborate, Article 5, OECD-patterned definition.

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1. *Editor's note:* An "N.V." is comparable to the French "société anonyme" or the German "Aktiengesellschaft". A "B.V." is comparable to the French "société à responsabilité limitée" or the German "Gesellschaft mit beschränkter Haftung".

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However, for foreign portfolio dividends, interest and royalties, the exemption method does not apply. Whether double taxation is actually prevented depends in the first place on whether a tax treaty is applicable and if not, secondly, whether the country where the dividends, interest or royalties arise is a developing country or not. Under tax treaties, the Netherlands allows the foreign withholding taxes as a credit against the applicable Dutch taxes (ordinary credit). Outside tax treaty relationship, a credit is only available according to the "Unilateral regulations" for portfolio dividends, interest and royalties arising in developing countries. For non-treaty, "non"-developing countries, the only relief available is credit against income.

No Eastern European countries are labelled developing countries under the Unilateral regulations. As we will see later, however, with almost all of them the Netherlands has a tax treaty in force or under construction.

Participation dividends

Under domestic law, going for both treaty and non-treaty countries, "participation dividends" are exempt from tax in the hands of the parent corporation, provided that the foreign subsidiary from which the dividends are derived has been subject to tax on its profits; whether tax has actually been levied is not relevant. This exemption applies also to gains derived from the disposal of a participation. Losses sustained by a subsidiary company are not deductible in the hands of the parent. However, if the subsidiary is liquidated, the loss suffered on that occassion is. Parliament is now considering to limit the scope of this deduction.

A qualifying participation exists if a Dutch parent corporation owns 5% or more of the nominal paid-in capital of a foreign subsidiary company. On request, the Netherlands Under Minister for Finance can determine that even smaller participations qualify for the participation exemption. Furthermore, the participation must not be maintained as an investment.

The condition that the parent must own 5% or more of the nominal paid-in capital of the subsidiary, implies that the subsidiary company has to be a company whose capital is wholly or partly divided into shares. Participation in partnerships and the like are thus not eligible for the participation exemption.

Source taxation

Although a number of tax treaties give the Netherlands the right to levy a tax on outgoing interest and royalties, except in a limited number of specific cases, the Netherlands cannot exercise its taxation right, because domestic law does not provide for it. There is tax at source of 25% only on dividends. This percentage is usually limited under tax treaties, to 15% for portfolio dividends and 5% or, in a number of cases, 0%, for intercompany dividends. Intercompany dividends in this context are dividends paid to a parent corporation who owns 25% or more of the share capital of the dividend paying company.

Non-resident taxpayers

Non-resident taxpayers are taxed in the Netherlands only on income from a limited number of sources in the Netherlands. The most important in this context are: employment exercised in the Netherlands, income from immovable property situated in the Netherlands, and profits from a permanent establishment within the Netherlands. The concept of permanent establishment is not defined in domestic law, but, as already mentioned, the OECD definition is followed to a large extent.

The Netherlands Antilles and Aruba

A special feature in discussing Dutch international taxation are the Netherlands Antilles and Aruba, Caribbean islands forming part of the Kingdom of the Netherlands, with responsibility for their own fiscal affairs. The Netherlands tax law does not apply to the Antilles and Aruba nor do the Dutch tax treaties. The Antilles has entered a few tax treaties themselves and are connected for tax purposes with the Netherlands via the "Tax Regulation for the Kingdom", virtually comparable with a tax treaty.

Taxable basis

For doing business with Eastern Europe, we can distinguish between very loose relations on the one hand – just selling some goods – very close relations on the other hand – a full local subsidiary, if local law permits it – and all the shades in between such as selling know how, providing services, lending money, or more actively: doing business through a representative, using a local state trade organization, the home state's trade representative, an independent agent, an employee on the spot, or a joint venture. For Dutch tax purposes as indicated above the OECD permanent establishment concept is generally used as a guideline in determining whether a Dutch resident has a p.e. abroad. If there is a tax treaty, the relevant treaty provision applies. In determining the profits to be attributed to a p.e. abroad, Netherlands accounting principles apply.

The result can be that the profits of a p.e. calculated according to local rules deviate from the outcome using Dutch standards. Nevertheless, for the amount to be exempt, the Dutch calculation is decisive. This can be very attractive if, as is not uncommon in Eastern Europe, profits of a p.e. are determined as a fixed percentage of turnover or contract value, or even as a fixed percentage of salaries paid by the p.e., or if there is a compulsory, tax-deductible, contribution to a reserve fund, assuming of course, that the outcome does not exceed the amount according to Dutch standards.

Furthermore, for being exempt from Netherlands tax, the level of foreign taxes is not of interest at all. Outside treaty relations, it only matters whether the profit

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has been subject to tax. Under tax treaties, even that question is not asked. This means that exemption also goes if, according to local law, profits of a p.e. are temporarily exempt from tax, for instance in order to attract foreign investment.

Rulings

Unlike a number of countries, the Netherlands tax administration can be approached in advance in order to acquire its opinion on the fiscal aspects of a planned transaction. Initially, individual tax inspectors were approached, but, as it appeared that tax inspector X was cheaper than his colleague, Y, the phenomenon of "inspector shopping" occurred. To put an end to this, a delegate is sent from every corporate tax inspectorate to the "ruling commission", headed by the Finance Ministry, and it is there that they agree upon certain standard rulings. Only recently, a number of these "standard rulings" were made public. Among those standard rulings are rulings which give a company certainty as to the applicability of the participation exemption, rulings that provide for the determination of the profits (so-called "spread") to be attributed to Dutch based intergroup finance companies or licence companies, and FSC rulings. Until recently, these rulings had not been published and were only known to a rather limited number of experts. Recently, however, the ruling practice was discussed in parliament and on that occasion the contents and text of major standard rulings were made public. Although this is not the right moment to go into detail on the subject, it is interesting to have a somewhat closer look at two of them, because they might also be of importance when structuring some Eastern European operations: the "finance company ruling" and the "licence company ruling".

The basics of the structures discussed here are that there must be a corporation, which in itself is real, but with specific activities that in itself are so limited that the amount of profits to be attributed to those activities can also be very limited.

For Dutch based *finance companies* the reward, to be considered "at arm's length" for intra-group borrowings, is fixed at 1/8% of the amounts borrowed annually (the "spread") and 1/4% for third party loans (reaching 1/8% for loans above a billion guilders and 1/16% for loans over 3 billion guilders). Conditions are that the finance company does not bear any currency risk or debtors' risk and that there is a reasonable interest involved in obtaining a ruling. A reasonable interest is deemed to exist if the amounts borrowed and lent out are at least 10 million Dfl. If we assume a loan amount of 50 million Dfl., the taxable basis is 1/8%, or 62,000 Dfl., and tax amounts to 42% of 62,500 Dfl. or 26,250 Dfl. Taking into account the fact that by establishing a Dutch corporation, one has access to the Netherlands tax treaty network, while the Netherlands do not levy a tax on outgoing interest, this is not a bad deal. It can even be better, because, although not officially published, it appears to be possible to fix the profit at even lower percentages than 1/8, if major sums of money are involved. For intra-group loans in excess of 2 billion guilders the rate declines to 1/16%.

Two final remarks on this "finance company ruling". First, if there is a tax at source on incoming interest, this tax is not taken into account in determining Dutch tax liability. Second, if a treaty partner inquires after the character of the Dutch finance company, the relevant information can be furnished under the treaty.

The *royalties company ruling* basically requires the same as the finance company ruling. A reasonable interest here is deemed to exist if royalties received annually are at least 150,000 Dfl. Furthermore, it is mandatory that the company is not running any currency risk or debtor's risk. If these conditions are met, the taxable amount of a Dutch based intermediary patent holding company can be fixed at 7% of royalties actually received for royalties up to 2 million Dfl. If royalties received exceed this amount, the next two million is determined at 6%; 4-6 million is 5%; 6-8 million is 4%; 8-10 million is 3%; and the excess is determined at 2%. For film royalties and lump-sum payments there is a fixed percentage of 6%.

For example: a Dutch based patent holding company obtains a ruling according to this so-called sliding scale, and receives 11 million Dfl. gross royalty, less withholding tax of 1 million Dfl., remains 10 million Dfl. Taxable amount:

7% of first 2 million	=	140,000.– Dfl.
6% of next 2 million	=	120,000.– Dfl.
5% of next 2 million	=	100,000.– Dfl.
4% of next 2 million	=	80,000.– Dfl.
3% of last 2 million	=	60,000.– Dfl.
		500,000.– Dfl.

tax 42%, or 210,000.– Dfl.

We see here that if there is any source taxation, it is deducted from the amount to be taken into account. As for exchange of information: the same applies as for the finance company ruling. There is no Dutch taxation on outgoing royalties.

II. TAX TREATIES

General remarks

The Netherlands possesses an extensive tax treaty network. Tax treaties are operating with almost all OECD member countries and with about 10 developing countries. What is more interesting in this context is that a large number of Eastern European countries have tax treaties that are in force or nearing completion.

The eldest tax treaty with an Eastern European country is at the same time the eldest Dutch tax treaty still in operation – that with Hungary of 1938.

A treaty that operated fairly satisfactorily, although it needs modernization.

A year ago, a new treaty was signed, but it has not yet entered into force.

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The second treaty is that with Czechoslovakia of 1974. Other treaties are with Poland and Romania, both of 1979, and one with Yugoslavia of 1982. Meanwhile, negotiations started with the Soviet Union that were concluded with the signature of a treaty in 1986, which has not yet entered into force, and which was published a few weeks ago. Of the two remaining Eastern European countries, negotiations are scheduled with Bulgaria in the course of this year. So far as I am aware, no plans exist to start discussions with the German Democratic Republic.

The remarkable thing about the Dutch treaties with Eastern European countries is that they bear a great resemblance to the OECD Model Conventions, although it is evident that no one is a member of the OECD. The more astonishing thing is that no Dutch treaty resembles the 1963 OECD Model more than the Czechoslovakian treaty, and no other Dutch treaty comes nearer to the 1977 OECD Model than the Polish treaty, the 1986 Hungarian treaty maybe excluded.

Whether this demonstrates the multi-purpose character of the OECD Model treaties, or illustrates the eagerness of the contracting parties to enter into a treaty relationship without too much discussion, the fact is that in almost all bilateral relations between the Netherlands and Eastern European countries tax treaties provide a secure and solid basis for the growing commercial relations between the countries concerned.

Inevitably, however, the treaties reflect to some extent the specific economic background of the treaty partners. Just as the Netherlands tries to insert some exceptions, originating from its domestic law, in its tax treaties, each of its treaty partners has its own specific preferences. We can notice, however, that several of the treaties have some deviations in common. Deviations that can also be found in other treaties with Eastern European countries, such as construction or building activities taking a longer period of time before being considered a permanent establishment, or even – as in Czechoslovakia – not deemed to constitute a permanent establishment at all. Another fairly common feature is the special treatment of road transportation, following the international air and shipping transport rule, meaning taxation in the home State (State of effective management), rather than the general profits rule taxation connected to presence of a permanent establishment.

Individual tax treaties

I would like to discuss the individual tax treaties the Netherlands has concluded with Eastern European countries. The order in which the treaties will be dealt with is that of signature, because that will enable us to detect historical developments in the treaties, if any. The order will be:

- Czechoslovakia (1974);
- Romania (1979);
- Poland (1979);
- Yugoslavia (1982);
- Soviet Union (1986);
- Hungary (1986).

Please note again that the latter two have not yet entered into force.

Czechoslovakia (1974)

I mentioned already that no Netherlands tax treaty bears more resemblance to the 1963 OECD Draft Convention than this one. This implies, of course, that deviations from the OECD Model are scarce and not far going. At the time the treaty was negotiated, Czechoslovakia did not have a tax on outgoing dividends. Nevertheless, the treaty provides for a tax at source of 10% for portfolio-dividends, 5 points lower than the usual 15% rate. The intercompany rate is zero, thus effectively reducing the dividend tax on proceeds from joint ventures introduced by Czechoslovakia since the treaty was signed. Combined with the Netherlands participation exemption, this means no additional tax burden after the joint venture level. For interest, the domestic rate is 25%, the treaty rate is zero; for royalties, the domestic rate is 30%, the treaty rate is 5%. These Czechoslovakian taxes are creditable against Dutch tax thereon. Unique for a Dutch tax treaty, but not uncommon for Czechoslovakia, is that a building site or construction or assembly project, normally constituting a permanent establishment if lasting more than 12 months, is explicitly excluded from the permanent establishment concept. However, whether this always is an advantage for the building enterprises concerned is questionable. If a Dutch building enterprise has building activities in Czechoslovakia taking more than 12 months, it would usually be considered to have a permanent establishment abroad, its profits being exempt in the Netherlands. Assuming that the Dutch and Czechoslovakian tax bases are the same, it depends on the actual tax rates – Dutch corporate rate being 42% – whether this constitutes an advantage or disadvantage.

Romania (1979)

Although the treaty was signed in 1979, thus after the publication of the 1977 OECD Model, it must have been negotiated before 1977 because it follows to a large extent the wording of the 1963 OECD Draft Convention.

Source taxation is limited to 10% for intercompany dividends, 15% for other dividends and 10% on interest and royalties. As in the Polish treaty, (operational) leasing payments are excluded from the royalty concept. A fairly common feature in Dutch tax treaties, if a rather substantial tax at source on royalties has been agreed upon. Interest paid to a bank or to the Government, or on loans guaranteed by the Government, is exempt from tax. Furthermore, the treaty contains a unique provision for Dutch tax treaties, a tax at source on commission payments of 5% with a net-election, coming from the Romanian domestic 15% rate. This is a one-way affair, as the Netherlands law does not provide for source taxation

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on commission payments. The Netherlands allows ordinary credit for Romanian source taxes.

The notion of "permanent establishment" deviates in certain respects from the usual one. Unlike other Eastern European treaties, however, the building site provision does not deviate: just a 12-month period. A difference is that a representative maintaining a stock of goods and regularly filling orders therefrom is to be considered a p.e., a provision that can also be found in the 1980 UN Model Convention. Furthermore, there are two somewhat unusual exceptions from the p.e. concept: selling goods exhibited at a trade fair or exposition subsequent thereto does not result in a p.e. A provision without much meaning because normally an exposition as such will not be considered to create a p.e., and if there is already an existing p.e., and the profits can be attributed thereto, this provision does not prevent you from so acting. Furthermore, press, radio and TV offices, meant to gather information, are not to be considered permanent establishments.

One could compare these types of activities with a purchasing office, which is not a p.e. either. Again, the international traffic rules – sole taxation right in effective management State – apply also to road transport, and even rail transport. For independent personal services, a fixed base is deemed to exist if the person involved is present in the State where the activities are performed for more than 1983 days. Once again reference is made to the 1980 UN Model Convention. Here too it is questionable whether the Netherlands, if the source State, is able to exercise its taxation right.

Poland (1979)

Although this treaty was signed almost at the same time as the Romanian treaty, unlike that treaty the Polish treaty already follows the 1977 OECD Model, and, as remarked earlier, to such extent that no other Dutch treaty exhibits such minor deviations from the model until the Hungary treaty of 1986 was published.

A few deviations in the treaty are also to be found in other Eastern European treaties: building site constituting a permanent establishment after a longer period than 12 months – in this case 18 months; transport profit article relating also to rail and road transport. Unique, however, in any Dutch treaty, is the rather extensive definition of what are to be considered transport profits.

Source taxation is limited – allowed only on portfolio dividends (the usual 15%) and industrial royalties (10%). However, to the extent that the recipient of the royalties proves that he is not able to credit the source tax against his home tax liability, the source State withdraws. For Dutch tax treaties, this too is a unique provision. The treaty contains no specific provisions relating to joint ventures.

Yugoslavia (1982)

This treaty too is to a large extent OECD-patterned. Still, it deviates more from the OECD Model than the Polish, Hungarian and Czechoslovakian treaties, which is peculiar, because, as the only Eastern European country, Yugoslavia has the status of observer to the OECD. The most "striking" deviation again relates to the building site: 18 months before it constitutes a permanent establishment. No extension of the scope of the international traffic provisions outside sea and air transport. Source taxation is rather limited: 5% on intercompany dividends, 15% on other dividends. However, since Yugoslavia does not levy a dividend tax, and since the treaty explicitly states that the proceeds of a participation in a joint venture are not considered dividends, source taxation is a one-sided affair.

Furthermore: no source taxation on interest, at least for the time being. If one of the States introduces such a tax, they will renegotiate. Source taxation on royalties is limited to 10%. A provision relating to the possible extension of the treaty to the Netherlands Antilles or Aruba is missing.

Soviet Union (1986)

The Soviet Union treaty reflects the specific Soviet approach to solving international double taxation. In other words: the treaty deviates on a great many occasions from the OECD Model and differs from the other Dutch treaties with Eastern European countries. Nevertheless, if we look upon the treaty as to substance, it isn't as bad as it looks at first glance. The OECD pattern has been maintained and part of the deviations is just wording. Furthermore there is no article on royalties, but an article on "payments for copyrights and licences". Some noteworthy deviations as to substance: no exchange of information (just notification of important changes in domestic tax laws); and, no treaty basis for an extension of the treaty to the Netherlands Antilles or Aruba. The p.e. concept is basically in line with the OECD Model. Selling goods after an exposition or trade fair, like in the Romanian treaty, does not constitute a p.e. Neither does "the performance of planning, development and scientific research activities, engineering, testing, technical services or supervisory or consultancy activities". The building site term is the usual twelve months. For longer periods there is a compromise: the competent authority of the State where the activities are exercised may, upon request, consider a building site taking more than 12 months *not* a p.e. Remuneration of employees engaged on the building site is, in so far as the building site does not constitute a p.e., only taxable in the state of residence. Usually, in cases like this, 183 days presence sets the limit.

Furthermore, if a fixed place is maintained only to facilitate the conclusion of specified contracts (loans, delivery of goods, technical services), it is not consi-

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dered a permanent establishment. As it appears to be impossible to do without such a fixed place within the Soviet Union, in order to conclude the relevant contracts, this is an important addition.

Profits from an enterprise as well as income from independent personal services are treated on the same footing. Again: a deviating approach not resulting in substantially different taxation. The rules, usually reserved for shipping and air transport, apply as well to other means of transport, like road and rail transport as mentioned before a rather common provision in relation to Eastern European countries. Source taxation is rather limited, only on dividends is there an overall withholding tax rate of 15%.

Except for distributions from joint ventures, the Soviet Union does not have a separate tax on distributions. There is no source taxation on interest and royalties.

Hungary (1986)

This treaty will soon replace the oldest operational Dutch treaty, that of 1938. Like the Polish treaty, it bears a great resemblance to the 1977 OECD Model and only shows some minor deviations. The p.e. concept is rather normal, the building site term being 12 months. Added thereto, however, is the fact that a construction, installation or assembly project in connection with the delivery of machinery or equipment, does not constitute a p.e. and a provision stating that "a fixed place of business includes also a fixed place of industrial activities", which for many people may seem rather superfluous. Whether profits are to be taxed in Hungary or in the Netherlands does not make much difference. Assuming the tax basis, the Hungarian corporate tax rate is 40%, the Dutch one 42%. There are no additional transport provisions, just the ordinary shipping and air traffic (no roads or railroads). Source taxation is rather limited: 5% for intercompany dividends; 15% in other cases; and no source taxation on interest and royalties. A somewhat peculiar provision is to be found in the protocol. Part I: "If one of the States intends to levy a tax on profit distributions made by a joint venture in the form of a partnership with foreign participation, then the competent authorities shall consult each other to reach agreement whether this tax can be levied under the provisions of this Convention". The answer to the question whether a tax on distributions from a *partnership* can be levied under the Convention seems to be negative. The treaty allows only dividend tax on distributions of a *company*. Whether the treaty allows source taxation depends upon the question whether Hungarian law treats a partnership as a body corporate for tax purposes. Dutch law does not. If Hungarian law does not either, the treaty has to be changed in order to permit this "branch profits tax".

And if it is still true that Hungarian law at present allows only joint ventures in the form of a company, this only adds to the confusion this provision creates. A few final comments: exemption in the performance State for State-supported artists, musicians or athletes. (A provision not uncommon in Eastern European treaties). There is limited exchange of information – just for treaty implementation, not for carrying out domestic law.

III. THE CYPRUS CONNECTION

Finally, before concluding I would like to spend a few moments on what can be called the Cyprus connection, specifically where Cyprus can be used as an intermediary for Dutch enterprises doing business with Eastern Europe, or for third country companies, using the Netherlands as a stepping stone. Let us first look at the Netherlands treaty position versus Eastern Europe, as compared to that of Cyprus. First consider dividends; specifically intercompany dividends. It appears that there is no better treatment under Cyprus tax treaties with Eastern European countries than under Dutch treaties. Even in those cases where the Netherlands have no treaty and Cyprus has – Bulgaria and German Democratic Republic – it does not make sense to interpose a Cyprus company, as the Cyprus treaty rate with Bulgaria – 10% – equals the Bulgarian domestic rate, and the German Democratic Republic does not levy a tax such as a dividend withholding tax. If we add the Cyprus tax on intercompany dividends of 1/10 of the domestic rate, coming down to 4.25%, given the fact that intercompany dividends are tax-exempt in the Netherlands, this even leads to a disadvantage.

Next item: interest. Under Dutch tax treaties, the withholding taxes are not higher than under Cyprus' tax treaties. However, for interest coming from the German Democratic Republic (a treaty country for Cyprus, but not for the Netherlands), interposing a Cyprus company could make sense in order to avoid the domestic withholding tax of 15%. As Bulgaria does not have a source tax on interest there is no advantage in interposing Cyprus.

For royalties there are more opportunities. For instance, for Bulgarian royalties, source tax goes as high as 81% (net basis). The treaty between Bulgaria and Cyprus contains a 5% rate for patent royalties (gross basis), and 0 for the rest.

For royalties from the German Democratic Republic, in the absence of a tax treaty, the rate in relation to the Netherlands is *25%*. Cyprus has brought that down in its treaty to *0*. In relation to Hungary or the Soviet Union, it makes no difference. For Czechoslovakia it matters whether it is a patent royalty – no difference, both 5% – or not. In the latter case, Cyprus has a 0 rate, the Netherlands 5%. For Romania, the Netherlands has a 10% rate overall – Cyprus has a 5% for patent royalties and 0 for the rest, so there appear to be some benefits in structuring via Cyprus.

IV. CONCLUSION

In conclusion, what will be the most optimal structure for a Dutch enterprise to enter the Eastern European

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market, and where can the Netherlands be useful as an instrument for third country residents planning Eastern European business operations?

For business operations in Eastern Europe, the Netherlands, because of its exemption system, forms a perfect platform: p.e. profits are exempt, dividends from a Eastern European subsidiary company (joint venture) are exempt as well. So from the Dutch side, except for the currency impact, it does not make much difference whether you use a p.e. or a sub, as long as you make a profit. However, if the Eastern European operation is expected to generate losses for a while, if local law permits, establishing a p.e. of a Dutch corporation seems the most attractive, specifically as we take into account that no Eastern European country has loss carry-over provisions as such. These losses can then be brought directly to the charge of Dutch headquarters which, of course, must generate profits in order to offset the losses. However, if the p.e. itself later starts making a profit, those profits are only tax-exempt in so far as they exceed losses of the previous 8 years.

The moment a loss turns into a profit, incorporating seems advisable, as later dividends then fall within the scope of the participation exemption. Two strings are attached: first, on the transformation from p.e. to subsidiary there is a possibility of recognition of goodwill which will be considered a p.e. profit to be offset against previous losses, thus, to that extent, not exempt. Secondly, there was a bill introduced in parliament stating that the participation exemption should apply only after dividends have made up for previous p.e. losses. However, whether this will be approved is questionable.

This same structure could, of course, also be used by foreign enterprises considering entering the Eastern European market. In order to make compensation of foreign p.e. losses possible, it is advisable to generate some profits in the Netherlands. When in a later stage profits are to be repatriated from the Netherlands, it has to be done under a tax treaty with a 0 or at least close to 0 withholding tax rate on participation dividends, taking into account the tax system of the home State.

For interest and royalties, the Netherlands is the preferred place to channel through if two conditions are met: First, the source State should levy no, or a very low, tax. We saw that in the case of Eastern European countries this condition is met for interest in almost every case, whether under domestic law or as a result of the relevant treaty. For royalties there are also very few cases of withholding tax. Second, as the interest and royalties received will result in taxable profits in the Netherlands – at 42% – the Netherlands should only be used as an intermediary and the intermediary should obtain an advance finance or patent holding ruling from the Dutch tax inspector.

Where the interest or royalties are going to or from the Netherlands is irrelevant from a Dutch point of view, because there is no source taxation on interest and royalties. Another possibility is to use Cyprus as an intermediary, for instance in order to collect royalties or interest which otherwise would have generated Dutch taxes and repatriate the amounts received as participation dividends to the Netherlands, or onwards. If, however, it is obvious that the whole structure was created only to avoid Dutch taxes one could be confronted with the Dutch *abuse of law* doctrine, a subject beyond the scope of my contribution, but certainly worthy of note.

In summation, the Netherlands has an extensive tax treaty network. It is completing tax treaties with Eastern European countries, treaties with competitive source taxation provisions and with other provisions beneficial to international business. Furthermore, basically the Netherlands exempts foreign profits as well as intercompany dividends from Dutch taxation and it does not have source taxation on outgoing interest and royalties, while tax treaties with other countries provide for a substantially decreased dividend tax and rulings are issued by the tax administration. This conglomerate makes the Netherlands a near to perfect basis for a great number of different transactions with Eastern European countries.

ANNEX

Source taxation in Eastern European countries/Netherlands

	Intercomp. div.		Portfolio div.		Interest		Royalties	
	Domestic rate	Treaty rate	Domestic rate	Treaty rate	Domestic rate	Treaty rate	Domestic rate	Treaty rate
Bulgaria	10[9]	–[1]	10	–[1]	0	–[1]	–81[8]	–[1]
German Dem. Rep.	–	–[1]	–	–[1]	15	–[1]	25	–[1]
Hungary (1938)	20	–[3]	20	–[3]	0	–[3]	–75[8]	0
Hungary (1986)[2]	20	5	20	15	0	0	–75[8]	0
Poland	30	0	30	15	30	0	30	10
Romania	30[9]	10	30	15	15	10[4]	25[7]	10[5]
Soviet Union[2]	20[9]	15	20	15	0	0	–81[8]	0
Czechoslovakia	25[9]	0	25	10	25	0	30[6]	5
Yugoslavia	—	5	—	15	0	0	35	10

Domestic rates Netherlands:
dividends 25%
interest 0%
royalties 0%

1. not applicable (no treaty)
2. not yet in force
3. no treaty limitation
4. no tax on interest paid to a bank or other financial institution or on interest on loan provided or guaranteed by Government
5. 5% for commission payments
6. copyright royalties 25%
7. copyright royalties 20%
8. net-basis
9. only on joint ventures

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AUSTRIA:

Taxation of Eastern European Source Income

Summary of a speech held at the First East-West Tax Conference in Salzburg on 15 April 1987

By Dr. Werner Albeseder

I. INTRODUCTION

Thanks to its geographic location and its neutrality, Austria is well qualified to serve as starting point for business operations in the COMECON countries of Eastern Europe and Yugoslavia. The common history of Austria with some Eastern European countries, especially with Hungary, is no encumbrance for economic activities in the Eastern European countries. In some cases, common history may even be a helpful connecting link.

Many multinational enterprises maintain subsidiaries or branch offices in Austria with the sole purpose of acting in the COMECON countries of Eastern Europe and Yugoslavia. It is rather easy for Austrian citizens to travel in those countries, not only because of short distance (56 km only from Vienna to the Czech and 59 km to the Hungarian border), but also because of the fact that Austrian citizens do not need a visa to travel to Hungary and Yugoslavia (in the last case this is true also for citizens of other European countries).

A short example may underscore the importance of Austria in doing business in Eastern European countries: currently, approximately 70 joint ventures are established in Hungary, 20 of them with the participation of an Austrian company.

2. AUSTRIAN TAX LAW

Individuals are subject to personal income tax and legal entities to corporate income tax. Partnerships and business forms which do not qualify as a separate legal entity are not subject to corporate income tax; however, in Austria the partnership is not a taxable entity under the personal income tax law either. It is the individual partner who is subject to personal income tax based on the share of his income from the partnership.

The concept of calculating income and profit, developed for purposes of personal income taxation, also applies to corporate income taxation. Generally said, profits are computed in the same way for personal income tax and corporate income tax purposes. Income is always computed for an income period. For individuals the period is the calendar year.

The personal income tax is levied at progressive rates ranging from 21 to 62%.

The income of corporations (joint stock companies or limited liability companies) is subject to corporate income tax. The rates of corporate income tax are also progressive and are ranging from 30 to 55%. On distributed income the rate is reduced by half. To enjoy the reduced rate, a formal shareholders' resolution authorizing such distribution is required. Accordingly, so-called hidden dividends do not qualify for a preferred tax treatment. The reduced rate, however, concerns the distributed portion of the profit only. If the entire profit after tax is distributed, it has to be taken into consideration that the corporate income tax on the dividends (which is payable from the company's profit) is itself subject to the full corporate income tax rate as undistributed profits. Because of the so-called shadow effect (Schatteneffekt) the corporate income tax burden in the case of full distributions does not amount to 27.5% (one half of 55%) in the highest bracket, but to 37.93%. In order to avoid the shadow effect the distribution has to be at least as high as the taxable income of the company. To achieve this goal, an increase of the distributed amount is necessary; such an increase is possible by means of using reserves by making use of the participation exemption or by tax-free profits or dividends from abroad under a double taxation treaty.

The participation exemption applies in cases where a corporate entity with unlimited tax liability (i.e. which is resident in Austria) has held – since the beginning of the fiscal (not calendar) year preceding the date of tax assessment – continued ownership of at least 25% of the share capital of a stock corporation or limited liability company also subject to unlimited tax liability. As of 1 January 1973 the participation exemption was extended to Austrian corporate entities holding such investments in foreign companies. The holding company must also be an entity with unlimited tax liability

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in Austria owning at least 25% of the share capital of the foreign corporation which is comparable to a domestic corporation (so-called international participation exemption). Thus, dividends paid by a foreign subsidiary to its resident parent company are not taxable in the hands of the recipient.

For 1 January 1989 a significant amendment of the corporate income tax system has to be expected. The highest normal corporate income tax rate will be reduced from 55% to 35-38%. The special rate (in case of profit distribution) will presumably be completely abolished. In the case of a holding situation the dividends earned by the holding company will be tax-free at any rate, not only in the case that the participation exceeds 25%.

Additionally partnerships and corporations are subject to a trade tax. For purposes of trade tax the partnership is an independent taxpayer. The trade tax amounts to about 14.5% of the partnership's income. It is deductible when computing the taxable income and for corporate income tax purposes.

Individuals are subject to a net wealth tax of 1% per year. However, corporations, as separate legal entities, are also subject to a net wealth tax amounting to 1% and to a substitute inheritance wealth tax of 0.5%. The participation exemption also applies to the wealth tax of the corporation, which means that the value of the participation is not subject to this tax; however, related debts are not deductible.

Under domestic law, dividends are subject to a withholding tax of 20%, if the participation exemption does not apply. For dividends in the hands of the individual shareholder the personal income tax is levied at half the rate which normally would apply to every single taxpayer. This rule also applies to dividends in the hands of a partnership.

When an Austrian company acquires a participation in a foreign subsidiary of more than 25% it is allowed to take a 10% depreciation in the first year irrespective of the actual value of the shares. In some cases this rule also applies if a loan is given to a foreign subsidiary.

The alienation of a participation by a company is generally subject to normal taxation. There is no special capital gains tax in Austria. If an individual or a partner in a partnership sells shares, the personal income tax is imposed at half the rate only (see dividends). Additionally, an amount of up to 100,000 AS of the alienation gain remains tax-free.

Especially, when doing business with Eastern European countries, it is often necessary to pay commission fees. Such expenses are recognized as tax-deductible even if the recipient is not mentioned by name provided that there is a direct connection with the order from abroad and that it may be assumed that the recipient is not taxable in Austria.

3. TAX TREATIES WITH EASTERN EUROPEAN COUNTRIES

Austria has concluded tax treaties with Bulgaria, Czechoslovakia, Hungary, Poland, Romania and the U.S.S.R. The treaties cover all taxes on income and property. In addition, a treaty covering estate taxes exists with Hungary. For details see Appendix.

There are definitions of a permanent establishment in each of the treaties. Building sites and construction projects are usually considered as permanent establishments only if they exist for a certain period of time. Usually the time limit is, as under Austrian national law, 12 months. Divergences exist in the following Austrian conventions:

Poland, Hungary, U.S.S.R.	: 24 months
Romania: building sites	: 18 months
construction projects	: 12 months

Dividends paid by a corporation established in Hungary or the U.S.S.R. are not subject to any withholding tax in the source country under the treaties. Dividends coming from Czechoslovakia, Hungary and Poland are subject to a 10% withholding tax, dividends from Romania may be taxed at source with 15%.

Interest paid from an Eastern European company is taxable in Austria: generally there is no withholding tax in the source country with the exception of Romania (10% withholding tax).

Generally, royalties are exclusively taxed in Austria; only Czechoslovakia (5%) and Romania (10%) levy withholding taxes.

The method used to avoid double taxation is generally the exemption with progression method. All treaties concluded with Eastern European countries contain a non-discrimination clause and provide tax authorities with the right to exchange information as needed to apply the treaties. Mutual agreement procedures are also provided for in all the treaties. However, there are no agreements about legal aid in collecting taxes between the Eastern European countries and Austria.

4. CYPRUS OFFSHORE COMPANY AS INTERMEDIATE (HOLDING) COMPANY

In cases where the Austrian international participation exemption would not apply because the foreign operation is not comparable to a domestic corporation, it may be recommended to interpose a Cyprus offshore company. The same may apply if the participation is less than 25%. However, it has to be said that it is not a common practice in Austria to interpose holding companies in tax havens or low tax countries. One of the reasons is that a participation in a foreign company is subject to approval by the Austrian National Bank (see below); an approval for a subsidiary in a country in which there are (and will be) no permanent economic connections of the potential Austrian parent company would be hard to obtain.

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5. AUSTRIAN EXCHANGE CONTROL REGULATIONS

There are still some foreign exchange control regulations left in the Austrian law.

The acquisition of a participation in a foreign company is allowed only under the condition that all persons participating in the foreign company have their domicile in a "multilateral member" state (i.e. countries which are members of IMF or OECD). The participation of the foreign company must lead to a permanent economic relationship between the Austrian and the foreign partner. The acquisition of foreign participation just for the purpose of an investment without personal economic interests (with the exception of certain foreign stocks and bonds) is prohibited. In the cases of "multilateral member" states the approval is generally given if the conditions are fulfilled; for participation in other countries special permission is required.

6. SUMMARY

Austria is certainly not a low tax country. However, the geographical location, the political status of neutrality, some provisions in the Austrian tax law and the double taxation treaties concluded with several Eastern European countries make Austria an interesting starting point for various economic activities with Eastern Europe.

APPENDIX

Convention for the avoidance of double taxation concluded between Austria and Eastern European countries

State	Federal law gazette in which the convention has been published in Austria	Scope of taxes covered
Bulgaria	425/1984	all taxes on income and property
Czechoslovakia	346/1979	all taxes on income and property
Hungary	52/1976	all taxes on income and property
	51/1976	estate taxes
Poland	384/1975	all taxes on income and property
Romania	6/1979	all taxes on income and property
U.S.S.R.	411/1982	all taxes on income and property

OECD:

International Tax Avoidance and Evasion

The OECD has just issued a report entitled "International Tax Avoidance and Evasion" (112 pages) which examines the ways used to avoid or evade taxes in an international context. It also describes the counteracting measures taken by governments.

Among the issues discussed are the ways in which tax avoidance and evasion may be carried out by syphoning profits to tax havens, by setting up base companies in tax havens and by using conduit companies in other countries to disguise income flows. The problems of detecting such operations are increased by the practice of bank secrecy which may make it more difficult for tax officials to verify income flows and this issue is also discussed in the report.

The report is the first in a new series entitled "Issues in International Taxation" which will bring together reports prepared by the Committee on Fiscal Affairs on double taxation, transfer pricing and tax compliance.

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GERMAN DEMOCRATIC REPUBLIC:

The Structure of Obligatory Payments to the National Budget and the Management of the Socialist Economy

By Erhardt Knauthe and Hans Spiller*

SUMMARY

The State finance system exerts an influence on the management decisions of socialist economic units by means of variable obligatory payments to the national budget, by means of credit relations and interest structures and also by means of obligatory insurance payments. Obligatory payments to the national budget provided support for the development of an intensive expansion of the production potential, one of the aims pursued in this case being restriction of the consumption of scarce resources. Labour, land and also material and energy consumption are of particular national economic significance in this context. A resource tax system has been developed in the German Democratic Republic during the past 15 years with the aim of restricting the consumption of these resources, which has modified the revenue structure of the national budget. The volume of revenue derived from this source has risen from 17.8% in 1980 to 24.95% in 1984. The profits of nationalized enterprises and combinations of enterprises have also been modified by the institution of these taxes, opening up new possibilities for more effective production.

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REVENUE STRUCTURE OF THE NATIONAL BUDGET AND MANAGEMENT OF THE SOCIALIST ECONOMY

The State financial system is an integral component of the planned State-controlled economy in all fields and at all levels. Socialist ownership of the means of production, the national budget as the main source of funds and the supporting State banking and insurance systems have permitted a differentiated deployment of financial resources in a manner which ensures the implementation of the economic and social policy of the State.

The comprehensive functions of the State finance system consist mainly of:

- financing the national economic growth process and the formation and distribution of the necessary monetary resources for the performance of the tasks set out in State plans (distribution function),
- encouraging social, collective and personal interests in order to achieve greater efficiency in all economic processes, including the effective use of material resources (stimulation function),
- controlling the formation and use of the gross social product, the disposal of the national income and material developments based on financial flows (control function).

The State financial system is in consequence a versatile management tool which is able, by means of its inherently interrelated constituents (the national budget together with the budgets of local bodies, the State banking and credit system, the financial system of socialist enterprises and the system of compulsory insurance with additional voluntary insurance), to exert a wide-ranging influence on the development of economic processes.

The compulsory transfers to the State (i.e. compulsory payments by nationalized industries, taxes on cooperatives, private handicraft enterprises, private industrial enterprises and individual citizens, together with contributions and fees) are incorporated in this overall concept. They are able to produce a specialized and differentiated effect in increasing the efficiency of production and on the primary distribution and redistribution between economic units and regional redistributions, to ensure an all-round development of territorial regions, so that the influence extends not only to the field of production, but also to the circulation and consumption of goods.

The most important compulsory payments to the national budget by State-owned enterprises and combinations of State-owned enterprises are:

(a) *Product-related taxes (turnover taxes)*
This tax variant has the effect of centralizing a part of net income (mainly from finished products) in cases

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where, as a result of pricing decisions at the national level, industrial sales prices for particular goods and services have been fixed above the calculated prices of enterprises. That means prices consist of three parts: cost, profit and turnover tax.

(b) *The production resources tax (levy on assets)*
The aim of this tax is to ensure an effective utilization of invested capital and working resources in the national sector and in the construction industry.

(c) *The net profit tax*
By determining the proportion of the net profits of State-owned enterprises and combinations of State-owned enterprises to be paid to the national budget, the State is able to administer this proportion of the net profits centrally in the budget in order to finance tasks of national importance. The level of the net profit tax is determined separately in each case for State-owned enterprises and combinations of State-owned enterprises, reflecting national minimum requirements for the efficiency of the industrial production process.

(d) *The manpower tax*
This tax, which has been designated the "contribution to social funds", is intended to ensure a more effective use and, in the final instance, a saving of labour.

(e) *Employer contributions to social insurance*
These contributions are allocated to a particular fund which, together with employees' social insurance contributions and substantial additions from the national budget, are used to finance social insurance benefits.

(f) *Miscellaneous fees and charges*
Various fees and charges, aimed at the direct saving of material resources and the improvement of environmental conditions also exist. These will be dealt with in greater detail in subsequent sections.

Further economic development in the German Democratic Republic is based on the increasing intensification of the economy by a wide range of economic and legal measures. Industrial activity during the past 15 years has enabled a planned and stable growth of the national income of an annual 4-5% to be achieved. Provision has been made for this level to be maintained or further increased in national plans up to the year 1990, the aim being a further rise in the standard of living by the joint influence of economic and social policy. This can only be achieved by an intensive expansion of the production potential in the national economy, accompanied by a small rise, if any, or even a partial reduction in the use of labour, materials, sources of energy and production funds. This is all the more necessary since some resources are only available on a restricted basis and both national economic conditions and world factors necessitate a sparing use of resources.

1. Limited resources

The following annual increases in sales, manpower and material resources (in the production sectors) have been recorded in the national economy during the past 10 years[1]:

Industrial sales	about 5%
Labour	less than 1%
Material	less than 3%
Capital resources	about 6%
Working resources	about 2%

The supply of labour is restricted as a result of demographic developments.

The available manpower resources will decrease in absolute terms for a few years after 1990. Since manpower resources are at present fully employed and this situation will continue for the next few years, the saving of manpower resources must be encouraged. An annual increase in the productivity of work will be necessary in order to achieve the required and planned growth in production. This will be done by the use of modern technology. The lower material consumption in relation to the growth in production corresponds to the requirements of product development and the greater refinement of raw materials, equipment and semi-finished products, with a consequent simultaneous saving in imports and investments in the raw material sector.

The reduction in specific energy consumption has been particularly effective. Basic resources have increased more rapidly than production. The aim during the next five-year plan is to achieve a better balance by increasing the effectiveness of investments and further extending the utilization of existing basic resources.

The increase in working resources (meaning stocks of materials, semi-finished and finished products) has clearly lagged behind the increase in production, which already displays a more effective stock system and an accelerated production cycle. The development of these elements of the production process in the direction of a more intensive type of expanded production potential will have to be implemented by a wide variety of decisions and measures at all levels (enterprises and combinations of enterprises, territorial administrative bodies, supported by central decisions on national economic policy). A key question in this connection is the continuous renewal of the production range to meet demand and the international standard of product development and technology. The experience of socialist planned economies has confirmed the value of supporting these processes not only by the necessary decisions on production and development structure in the national economy, but also by economic regulations. Greater delegation of responsibility to enterprises[2] and to sectoral and territorial administrative bodies have created the necessary conditions for combining centralized and decentralized

1. Calculated in accordance with the *Statistisches Jahrbuch der DDR* [Statistical Year Book of the GDR], Staatsverlag Berlin, 1985.
2. The term enterprise will be used throughout the paper to mean State-owned enterprises and combinations of State-owned enterprises.

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decisions. Economic scales of assessment are required in this case as decision-making criteria.

2. The role of money, financing and credit in promoting an intensification of the national economy

Money, financing and credit are used not only to finance the production process, but at the same time for purposes of economic stimulation and control. The active and relatively independent role of financial resources in the socialist planned economy is being exploited at the present time to an increasing extent and on a planned basis to promote the growth and to improve the structure and proportions of the rapidly expanding production process in the national economy. At the same time, the active role of financial resources has to be linked with their economic accounting system and in particular with the profitability principle and the aspect of material expediency. Economic accounting systems in enterprises must be perfected so as to achieve a greater degree of harmony between social, collective and individual interests.

3. The active influence of taxation on the utilization of resources

One aspect of the active influence of financing on the production process is to be found in the effect of resource taxes. The further development of the category of expanded production is linked to a large extent with the relatively small-scale use of the most important resources. The structure of finance and credit relations and the prices of particular goods used during production are therefore intended to stimulate the manufacture of more refined products.

In the subject under examination the assessment of the utilization of money categories is concentrated on the resource taxes which, taken as a whole, have given rise to substantial changes in the structure of the national budget. First of all, we shall consider these taxes as constituent elements in the economic accounting systems of enterprises.

4. General view of the principal resource taxes and their field of application

For purposes of this review, resources will be understood to mean:
- manpower (labour resources);
- land;
- production funds (fixed assets and working capital);
- raw material and energy inputs;
- water;
- air; and
- transport capacity.

The concept underlying resource taxes is that the utilization of resources in the form of labour and materials should give rise to an improved product which passes into the ownership of society. The social appropriation process includes elements at the enterprise and State level, so that a step-wise appropriation of the improved product occurs. The centralization of resources by means of the State financing system in the national budget includes, of course, elements other than the resource taxes, but the effect of those taxes is to centralize a sufficiently important part of the improved product to influence the decision-making behaviour of enterprises and at the same time to permit a measure of stimulation and control of those enterprises.

A system of resource taxes has been built up in the German Democratic Republic over a period of almost 20 years, all the time closely integrated in the mechanism of economic accounting. The question of the extent to which resource taxes can be regarded as taxes as defined in a socialist economy will not be considered further in the context of this study[3]. At all events the amounts paid have to be earned in the enterprises and they form an important element in the revenue of the national budget.

The stimulatory function of these resource taxes is to be found in the fact that an effective resource utilization will result in a reduction in the taxes, either in absolute terms or in relation to output (turnover), or in complete exemption from resource taxes. In this case the net profits will be correspondingly higher and the opportunities for building up capital funds within the enterprise greater.

Some of the more important resource taxes are reviewed below (in principle in chronological sequence):

Land utilization fee (adopted in 1968, a new version was issued in 1981 with greater differentiation from various points of view). The land utilization fee consists of a single payment in respect of areas of land or forest in permanent use. The rate varies according to the previous use of the land up to a total of 400,000 marks per hectare. In the case of the temporary use of such areas of land, a proportional fee is payable per month or per year. The land utilization fee is payable by the new user of the land. Enterprises are required to show the land utilization fee as a part of the investment costs without the possibility of depreciation. This results in a non-recurring expenditure in the profit account on investments and a larger basis for the current calculation of the production fund tax.

The aim of the land utilization fee is to bring out alternative investment solutions which restrict the use of land and to stimulate by economic means variants which counter the trend toward a reduction in the area of land under agricultural cultivation. Investments which require only very small additional areas of land, if any, are cost-saving for the enterprise.

Production resources tax, respectively in trade: commercial resources tax (adopted in 1971). This tax is payable annually at a fixed rate (in general 6%), in relation to productive funds. The latter included in the initial version the basic resources at their mean value,

3. Reference may be made to the paper by the authors in the "Reform of Tax Systems" – Proceedings of the 35th Congress of the IIPF, Taormina 1979, Wayne State University Press, Detroit, 1980, at 438.

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the land utilization fee shown as an asset and the planned mean stocks of working resources. Various exemptions are given, for example, in respect of basic resources in the cultural-social sector.

In 1982 the principle was extended to incomplete investments and in 1984 the standard rate was increased to 12% in respect of:
- incomplete investments from the date of scheduled commissioning until the date of actual commissioning (i.e. in the case of delayed completion, no levy is paid between the date of early commissioning and the date of scheduled commissioning);
- certain specified basic resources (items of equipment), which are temporarily utilized at below 90% of their capacity, in accordance with a predetermined differential guide scale;
- excess stocks of working capital (exceeding the standard schedules for stocks).

In 1986 the basis of calculation of the production tax on basic resources was changed from gross to net values (gross values less depreciation). This was accompanied by a differentiated increase in the previously fixed rate of 6%, since the net value as a basis of calculation is lower (the 6% rate remains in force for material working capital).

The aim of the production fund tax is to ensure effective utilization of the invested basic resources and the working resources. The differentiated rates are intended in this case to produce various specific effects such as:
- a planned utilization of capacity,
- completion of investment programmes on time or early,
- a preference for the modernization of existing basic resources (fixed assets) rather than new investments[4],
- economic stock management (stocks of materials and finished products),
- a rational production technology, necessitating relatively small stocks of unfinished products.

Dust and waste gas levies to reduce air pollution (adopted in 1973). The financial penalties for exceeding a standard pollutant level (emission limit values) are payable to the Regional Council [Bezirk], which passes the amounts received to the particular municipal and rural authorities which have to deal with the pollution. The level of payment is determined by the regional hygiene inspection service at the request of the local council, on the basis of widely differing tables and tariff scales.

Regulations to encourage reduced material and energy consumption (adopted in 1976, 1980 and 1982). In these years numerous stringent regulations were introduced. In the first place there was financial recognition of material savings by workers who were able to improve on the material and energy comsumption norms. These were single payments, representing a proportion of the material costs. If the raw materials, working materials and sources of energy were of importance in the national economy, the financial recognition was weighted by means of multipliers. The effect of these payments is comparable to a "negative tax".

Indirect encouragement to reduce the consumption of raw materials, equipment and energy sources can be given by the imposition of product-related taxes, which operate on the principle of a turnover tax. The prices for raw materials, equipment and energy sources can be calculated in relation to the consumption figures, the prices being periodically adjusted upwards or downwards in accordance with the consumption. In the case of some materials the product-related tax can be levied on the manufacturer or supplier, so that it is then passed on as a cost component to the user of the material.

Price ratios, established at the national economic level, can then exert an economic influence on material consumption, material substitution or again the relationship between the consumption of imported materials or items of domestic supply. Experience has shown that a sound material economy can yield results of advantage to the national economy, since each quantitative unit used becomes more cost-effective.

The waste water levy (adopted in 1982) is payable if a fixed pollution level is exceeded. In addition, a *water utilization fee* has been introduced in order to regulate the uptake of waters from lakes and rivers, the user being required to calculate the price himself on the basis of a predetermined price scale. If a greater than authorized quantity of water is used, a higher price is charged as a penalty. All these payments are made to the water industry administration.

Transfer of a proportion of the profit to the national budget if the manpower plan is exceeded (up to a maximum amount for each additionally employed worker) (adopted in 1982).

Tax on manpower (adopted in 1984). This tax, which is known as the "contribution to social funds", amounts to 70% of the total wages and is payable by enterprises to the national budget. It may be included in calculations as part of the production costs.

The aim of this tax is to foster a greater appreciation of the live work-force in the production costs. It is also intended to compensate for part of the resources required by the State for financing its social policy. These amounts have to be earned in the enterprises, but no specifically earmarked funds are established in the national budget. At the same time, if workplaces are eliminated as a result of automation, this reduces production costs with a favourable effect on the obtainable rise in profit.

5. The increase in the resource tax fraction in the national income

The most important of the sources of revenue described above are the items of income paid directly to

4. Where modernization is undertaken in place of complete new investments, the net values of these basic resources and in consequence the production funds levy to be paid will be lower.

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the national budget, i.e. the production resources tax and the manpower tax. The ground utilization fee and the water utilization fee are also allocated expressly to the national budget. The product-related tax incorporated in part in material prices (turnover tax) forms only the smaller element in the budget income from total receipts of turnover tax, since the latter is imposed mainly on finished products. The remaining resource taxes are contained in the payments in respect of profits or are redistributed at communal levels (for example, in the form of dust and waste gas levies). The revenue structure of the national budget has been given in *Annex 1* for the years 1980, 1983 and 1984, which reveal the following main trends. The resource tax function in the payments made by enterprises to the national budget has risen from 20.5% (1980) to 32.1% (1984).

The overall fraction of resource tax payments in the national revenue has risen from 17.8% (1980) to 25% (1984).

No further increase is required. The question which has to be considered is whether or not the present restructuring of the tax system has achieved the intended aim of a more effective utilization of human and material resources. The criterion on which this assessment has to be based is whether growth conditions have been achieved which correspond to the required intensive expansion of reproduction. The profit and net profit factors have a special part to play in these growth relationships, since it reflects in the most concentrated form the effective utilization of human and material resources. It is therefore one of the most important characteristic criteria determining the level of additional funds which can be used to reward workers in enterprises and to cover production requirements.

6. The influence of resource taxes on decision-making processes in enterprises

The principal connections between resource taxes and the decision-making process will first of all be illustrated in three presentations of the subject, particular reference being made to quantitative connections. The economic criteria of an assumed enterprise X have been given at *Annex 2,* as an illustration of the effects of resource taxes and of the different decision-making behaviour of the enterprises.

Presentation 1

Resource taxes provide a criterion for assessing the effective utilization of manpower and production resources. Against the background of a planned industrial activity of enterprises to meet demand, these intensification factors have to be used so as to achieve a greater output (profit), thus guaranteeing the operating and national economic reproduction process.

The manpower tax (contribution to social funds) amounts to 70% of the total wages. In the demonstration example (Annex 2), the figure given under this head is 3.8 million marks, which are contained in the costs and have already guaranteed the required profit. The production resources tax amounts to 6% of the net value for basic resources and circulating resources. In the example in question 6% of 70 million marks amounts to 4.2 million marks. The production resources tax has to be paid from the profit, leaving the net profit which must be large enough to cover the planned aims of expanded production. The net profit is used for the formation of a fund to stimulate the activities of employees in the enterprise, for the repayment of investment credits, for financing planned investments, for redistribution within the combination of State-owned enterprises and for proportional payments to the national budget (payment on net profit). The net profit is a critical element in economic accounting and provides the main criterion of the effective operation of the enterprise. The level of the employee stimulus fund will depend on the net profit. The return on investment (turnover) has therefore to cover:

- production costs;
- the manpower tax (contribution to social funds), which is contained in the costs;
- the production resources tax (contained in the profit);
- the net profit; and
- the product-related tax (turnover tax), where it is levied.

During the first few months of 1986 enterprises in the German Democratic Republic published their estimated production figures and obligations for the Five-Year Plan 1986-1990, in which they endeavoured to achieve appropriate additional production ratios. The measure of their dynamic approach is of course reflected, depending in each case on the given conditions, in different growth rates.

Presentation 2

Resource taxes are to some extent imposed as a penalty. They are intended to promote compliance of the operational production process with scheduled planning. If the chronological utilization of specific important basic resources is lower than the standard number of hours, a 12% increase in the production resources tax is imposed in respect of this equipment. If we postulate that in enterprise X basic resources having a net value of 20 million marks are not fully utilized in accordance with the time standard, the enterprise will be liable to pay an additional 6% = 1.2 million marks with a corresponding reduction in the net profit. Similar examples can be given of failure to complete capital investment programmes in time or exceeding the planned stocks of working resources. Where these excessive stocks are financed by credits, the effect of the interest factor has to be taken into account as well. In the German Democratic Republic interest is regarded as a cost component which may only reach the level permitted in the plan. Additional interest charged and increased penal interest rates have to be covered from the operating results. The basic interest rate, payable to State banks in respect of credits granted to enterprises, amounts to 5% p.a. Interest rebates of up to

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1.8% may be granted if the agreed performance and efficiency targets of the enterprise are exceeded or if additional tasks of national economic importance are taken on.

Failure to achieve agreed performance and efficiency targets or temporary deviation from planned figures can result in additional interest being imposed up to a total rate of 8%. A penal interest rate of up to 12% may be imposed in the event of contravention of the credit agreement. The dust and waste gas levies, waste water levy and standing levies for immobilizing transport resources (railway wagons and containers), as referred to above, are also intended to have a penal effect. If more than the planned number of workers are employed, a proportion of the profit earned by these workers will be diverted to the national budget.

Presentation 3

Taxes are intended to exert an influence on decisions regarding the use of national economic resources in the direction of achieving an intensive expansion in production. The variants selected shall be advantageous both to the national economy and also to the enterprise. One example of this is the need to calculate, when planning capital investments, whether an additional surface requirement is cost-effective. If, however, reconstruction on the previous surface of the factory is impossible, the ground utilization charge has to be "invested", thus giving rise to a one time increase in the outlay and after commissioning of the plant a permanent increase in the production resources tax. Where the expanded production is still cost-effective under these conditions, this will mean that the national economy and the enterprise have a common interest. Since the production resources tax is linked with the net value of the basic resources, the modernization of the latter by general repair and overhaul is a more favourable solution than new capital investment, since in the case of general repairs the current market value of the existing basic resources, as shown in the balance, is not increased. If, however, the enterprise decides in favour of new capital investment, the current value of the basic resources will initially approximate the procurement price. The production resources tax is accordingly higher, since the basis of calculation – the net value – is initially higher. In order to achieve an increase in the net profit, the investments must be cost-effective to a more than average degree, so that a higher efficiency target has to be set for the investment.

If automation solutions are adopted with a simultaneous saving of workplaces, the effect on the manpower tax will help to promote efficiency both for the enterprise and the national economy. The aim pursued by the national economy is the performance of expanded production tasks with the same or a smaller workforce, so as to conform to demographic development. Although automation means that the remaining workforce will in general acquire higher qualifications and earn more, the total wage bill for the sector will fall, so that there is a corresponding saving on the manpower tax. This permits additional profit from automation or on the other hand enables the very much higher depreciation rates on capital equipment to be borne.

Experience attained so far in this field may be summarized as follows:

1. The effect of an inadequate utilization of the capacity of basic resources is particularly clearly marked, since, with a large proportion of less than fully utilized basic resources, the production resources tax will rise. The reasons for this may be delay in changing over to new products, resulting in arrears of production; or it may be that with new capital investment the bringing into operation and full utilization of equipment requires too long a period. Enterprises are now making more intensive efforts to master these processes.

2. Stocks are now being held on a less generous scale.

3. Decisions in regard to modernization or replacement of basic resources are mainly governed by technological factors. It is not at present possible to detect any particular influence of the production resources tax on these decisions.

4. The manpower tax is encouraging the comprehensive automation of production processes and the use of computerized data processing systems for the preparation and control of production processes. The manpower tax is an important item in cost calculations. Enterprises are deliberately looking for technological solutions which will permit increased production, in general with the same or an absolute reduction in the labour force. This will take full account of the requirements of the national economy and of demographic developments in the German Democratic Republic.

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ANNEX 1

STRUCTURE OF BUDGET RECEIPTS OF THE GDR[1]

	1980		1983		1984	
	1000 marks	%	1000 marks	%	1000 marks	%
Total budget	160,652	100	192,409	100	213,534	100
Among them receipts from enterprises and banks						
1. Turnover tax	39,338	24.5	39,283	20.4	50,242	23.5
2. Levy on assets	18,233	11.3	22,910	11.9	25,089	11.7
3. Levy on net profit	40,094	25	55,680	28.9	40,411	18.9
4. Levy on labour	—		—		20,093	9.4
5. Taxes of agriculture	1,417	0.8	1,424	0.7	5,102	2.4
6. Taxes of craftsman co-op.	3,074	1.9	4,018	2	3,756	1.7
7. Taxes of private sector	3,029	1.8	3,795	1.9	4,004	1.8
8. Transfer payments of banks	6,051	3.7	7,307	3.8	7,624	3.5
9. Levy on land	300	0.18	177	0.09	207	0.1
10. Payments for water use	173	0.1	398	0.2	543	0.25
11. Social insurance contribution	8,641	5.3	9,350	4.8	9,563	4.5
	120,350	74.58	144,342	74.69	166,634	77.75

As levies imposed on resources employed are considered the positions under 2, 4, 8, 9, 10.
The share of levies on resources on total payments of enterprises is
20.5 21.3 32.1%.
The share of levies on resources on total budget is
17.8 16.1 24.95%.

1. As reported in the budgetary account for the years 1980, 1983 and 1984, approved by the Volkskammer [People's Chamber] of the German Democratic Republic.
Payments to the national budget by State banks originate mainly in credit transactions with enterprises. These represent the net profit of the banks as the difference between the interest rates charged or allocated credits and the interest rates paid on assets in the bank accounts of enterprises.

ANNEX 2

ECONOMIC CHARACTERISTICS OF ENTERPRISE X

		(in million marks)
Production of goods (turnover)		100
Costs		93
Profit		7
Production resources		110
including: Basic resources, gross	80	
Basic resources, net	40	
Material circulating resources	30	
Production resources tax (simplified) 6% (of 70 million)	4.2 million	
Net profit	2.8	
Workforce	455 persons	
Total wage bill	5.4	
Manpower tax (70%)	3.8	

Examples

1. The enterprise is experiencing difficulties in the sales field. Failure to sell goods has resulted in the stocks of circulating resources being 10 million marks higher than planned. This would result in an additional production resources tax, amounting to 12% (= 1.2 million marks) plus 8% penal interest in view of the credit situation (= 0.8 million marks). This would reduce the net profit of the enterprise in this example from 2.8 to 0.8 million marks.
2. In this enterprise basic equipment valued at 10 million marks is being utilized below standard capacity on a time basis throughout the year. The enterprise is therefore liable for an additional 6% production resources tax (= 0.6 million marks). This would reduce the net profit from 2.8 to 2.2 million marks.
3. The decision has to be taken in the enterprise as to whether the performance capacity of the basic resources is to be maintained and increased by modernization or by replacement capital investment. Provided that both variants are feasible, the results will differ in the amount of production resources tax for which the enterprise is liable. With modernization the production resources tax will remain unchanged, whereas replacement capital investment will result in an increase in the net value of the basic resources (for example, with a capital investment figure of 5 million marks and an annual depreciation of 10% [= 0.5 million marks], the mean value during the first year's utilization would be (5 + 4.5) : 2 = 4.75). The additional production resources tax would amount to 0.28 million marks, so that the net profit would fall from 2.8 to 2.25 million marks. The management of the enterprise will then have to decide whether this reduction in the net profit will be outweighed by other factors, reduced waste during production, the higher quality level obtainable with the new equipment or an increase in profit due to a higher production volume.
4. An automation project will enable a saving of 20 workplaces to be made on the basis of a cost per worker of for example 21,600 marks (consisting of his wages, manpower tax and employer's social insurance contribution); this would amount to an annual saving of 0.43 million marks, thus raising the net profit from 2.8 to

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3.23 million marks. This saving has to be set against the capital investment cost in the cost-benefit calculations. Assuming an investment cost of 0.1 million marks per workplace, the total capital investment costs would amount to 2 million marks, thus increasing the production resources tax by about 0.1 million marks as a result of the new capital investment. Account has also to be taken of the depreciation factor (amounting at 10% to 0.2 million marks). The net profit would accordingly fall by 0.1 + 0.2 = 0.3 million marks. It is evident that the investment of 0.1 million marks per workplace saved is barely profitable (the increased profit due to the saving of 20 workplaces is 0.43 million marks, while the reduction in the net profit due to the increase in the basic resources of the enterprises is 0.3 million marks, yielding an increase in the net profit of only 0.13 million marks) so that more economic variants have to be looked at (further changes in the cost situation have been disregarded). If the capital investment includes equipment from a rationalization programme within the enterprises, this will involve an entitlement to a 2-year exemption from production resources tax, with a consequent favourable effect on the cost-benefit calculation.

These examples make it clear how resource taxes enable operational decision-making criteria within the enterprise to be brought into line with the national economic aim of an intensification of the reproduction process.

OECD:

INTERNATIONAL SYMPOSIUM ON TAX REFORM IN DEVELOPED COUNTRIES

The main industrialized countries are either considering or have already implemented important tax reforms. An exchange of views on their different experiences took place at a symposium organized by France in association with the OECD on 12 and 13 January 1987. The meeting brought together 140 ministers, politicians, academics, tax officials and members of the business and trade union communities from 25 countries. The proceedings of the symposium have now been published by the OECD.

The discussions focussed primarily on personal and corporate income taxes and covered the following issues:

- choosing between tax incentives and lower tax rates;
- taxation of the lower paid;
- favourable tax treatment for savings and its impact on the level and distribution of household savings;
- desirability or not of adjusting the income tax base and system for inflation;
- the economic double taxation of dividends and its impact on investment decisions and on the international allocation of capital.

Many participants agreed on the need to cut tax rates, which during recent years have substantially increased in most industrialized countries. It was recognized, however, that the need to finance Budget deficits may limit the scope for any reduction in taxation.

The approach favoured to finance this cut in tax rates was to widen as far as possible the tax base by eliminating certain tax exemptions and allowances.

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ROMANIA:

Taxation of Joint Ventures and Non-residents

By Ioan Condor

I. THE GENERAL LEGAL FRAMEWORK OF FOREIGN ECONOMIC AND FINANCIAL RELATIONS

A. General aspects

Exchange of goods, services and capital as well as international economic co-operation have grown at an unprecedented rate. In our time, the promotion and widening of international co-operation have become an objective necessity for the progress of each country, the development of human civilization in general, and an essential prerequisite of a climate of trust among peoples. Therefore, Romania also considers the broadening of commercial exchanges and of economic co-operation in production with other States and the active participation in the international division of labour as inseparable elements in the process of her own development.

B. Foreign investment

International economic co-operation occupies an important place in the foreign economic policy and in the strategy of building a modern economy in Romania. The main fields of activity covered by international co-operation agreements are: co-operation in production (industrial co-operation); scientific and technical co-operation; co-operation in marketing and commercialization; banking co-operation; co-operation in granting of credits; and co-operation in productive services. Each of the fields of international co-operation presents its specific traits as to the concrete forms of manifestation.

Law 1/1971 which contains the general principles and establishes the framework of foreign economic exchanges devotes a chapter (V) to international economic co-operation, in which it is provided that the concrete forms of this activity may be varied depending upon the interests of the national economy, the object of co-operation and the destination of products (Art. 56). Likewise, it is provided that Romanian economic organizations may co-operate with foreign firms or economic organizations in building common economic objects in Romania and abroad. The same law also establishes the legal framework for creating joint ventures in Romania. Participation of Romanian enterprises in co-operative ventures is approved by the competent bodies.

The international legal framework of economic and technical-scientific co-operation is constituted by bi- and multilateral *treaties* to which Romania is a contracting party or to which it had acceded and which also contain mutual facilities which the contracting parties grant to each other. Thus, for example, beginning with 1976, Romania has concluded and ratified 20 bilateral treaties for the protection of foreign investments with the following countries: Austria, Belgium, Cameroon, China (People's Republic), Denmark, Egypt, France, Germany (Fed. Rep.), Italy, Malaysia, Morocco, the Netherlands, Pakistan, Senegal, Sri Lanka, Sudan, the United Kingdom, United States and Yugoslavia.

Joint ventures are a modern form of co-operation, used in several fields (production, commercialization of goods, finance and banking, insurance) because of their high economic efficiency. Therefore, the general provisions of Law 1/1971 relating to joint ventures have been developed through State Council Decrees.

Decree 424/1972 for the establishment, organization and functioning of *joint ventures in the Socialist Republic of Romania* (published in the Official Gazette, No. 121 of 4 November 1972) establishes, in essence, the following:

- the agreement on a partnership and the articles of incorporation are to be approved by the State Council;
- two types of companies may be established – with shares and with limited liability;
- the Romanian partner must have a minimum of 51% of the capital.

The Decree does not contain detailed rules concerning the organization and functioning of joint ventures, limiting itself to specify that these aspects will be regulated by the agreement on partnership and the articles which are approved by the State Council when establishing the company, thus becoming the proper "law of the co-partners".

On the basis of the above-mentioned provisions, a number of joint ventures were created in Romania.

The legal framework of the international economic co-operation schematically analyzed ensures a blending between the characteristics of our socialist economy and the interests of foreign investors.[1]

General fiscal aspects

Romanian tax legislation concerning natural or juridical persons operates under the principle of non-dis-

1. Rucăreanu, I. and Tănăsescu, V., *Legal forms of joint ventures with foreign participation in S.R.R.*, "Studii şi cercetări juridice, No. 2/1973, pp. 239-255; Gr. Florescu, *Joint ventures in Romania. A new form of international co-operation*, Bucharest, 1977, pp. 41-42 (Both works are in Romanian).

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crimination, providing (as in the case of Decree 153/1954 on the population's income tax), that taxes be paid on incomes and property without any distinction between Romanians and aliens.

The expansion and diversification of economic and financial relations of Romania with other states, the deepening of the division of international labour, and the desire to facilitate co-operation with foreign partners created the premises for establishing an adequate fiscal system setting forth specific fiscal obligations. To this end the following legislation was enacted: Decree 15/1971, concerning the authorization and establishment of offices of foreign trade companies and economic organizations (which also comprise their taxation system), Decree 425/1972 concerning the profits tax imposed on joint ventures established in Romania and Decree 276/1973 governing certain incomes derived within the Socialist Republic of Romania by natural and juridical non-resident persons.

In addition to the above-mentioned unilateral measures, since 1973 actions have been taken to promote the conclusion of agreements aimed at the avoidance of double taxation of income of goods with a view to removing fiscal difficulties which could hamper the normal development of economic international relations and ensuring the common economic interest of co-partners and the promotion of international exchanges, under the conditions of the continuous growth of international Romanian exchanges. In this context, it should be noted that Art. 6 of Decree 276/1973 provides that where an agreement for the avoidance of double taxation exists between Romania and another country or where other international agreements exist to which Romania is a party the provisions of such agreements regarding income tax shall be applied.

In this direction, Romania has concluded and ratified 25 bilateral fiscal international conventions[2] and two multilateral conventions[3]. This legal framework, as established by domestic laws and international agreements, is directed towards assisting the future development and expansion of the international exchange of material and spiritual values and, it is hoped, will result in mutual advantages for all countries participating in this exchange.

II. TAXATION OF JOINT VENTURES

A. Destination and distribution of profit

From the profits obtained by the joint ventures with headquarters in Romania, a reserve fund is set up and the tax due to the Romanian State is paid. The remaining profits are distributed among the co-partners in proportion to their share of the equity capital and for further development of the joint venture (Decree 425/1972).

B. The taxable base

The taxable base is equal to the annual profits prior to any distributions to the co-partners.

The taxable profits are calculated as the difference between the total amount of income received less the total expenses incurred to achieve such income, in accordance with applicable legal provisions and with the joint venture contract and statutes.

In determining the amount of taxable profits, the "reserve fund" is deducted by adding in up to a maximum of 5% of the profits for each year until the total reserve fund is equal to 25% of the invested capital.

C. Rates of taxation

Profits of joint ventures on the territory of Romania are subject to an income tax which is levied at a rate of 30% on the annual taxable profits.

D. Exemptions

An exemption from the tax on joint venture profits may be granted by the Council of Ministers. Such exemption will normally apply until the end of the year in which the joint venture first begins to generate taxable income. In cases where the point at which the joint venture first begins to generate taxable income falls in the second half-term of the year, the tax exemption may also be granted for the first half-term of the following year.

E. Reductions

Tax reduction of 50% may be granted during the 2 calendar years following the year in which the joint venture first begins to generate taxable income.

In order to stimulate the use of profits in Romania in cases where the joint venture profit is wholly or partially either re-invested into the same venture, or wholly or partially invested in another joint venture having Romanian participation, provided that such investment or re-investment is maintained for a minimum term of 5 years, the tax attributable to the invested profit will be reduced by 20%. In case of non-observance of this condition, this 20% reduction will be cancelled, the normal tax rate reinstated and a 0.05% increase for each day of delay will be applied from the due date of the respective tax.

F. The calculation and payment of the tax

The tax for the current year is provisionally calculated

2. The conventions concluded with: Austria, Belgium, Canada, Cyprus, Denmark, Finland, France, Germany (Fed. Rep.), Italy, Jordan, Japan, Malaysia, Morocco, the Netherlands, Norway, Pakistan, Spain, Sri Lanka, Sudan, Sweden, Turkey, the United Kingdom, the United States, Yugoslavia and Zambia.

3. These two conventions are concluded by: Bulgaria, Czechoslovakia, German Democratic Republic, Hungary, Mongolia, Poland, Romania and the U.S.S.R.

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by a joint venture within 5 days after the compilation of its balance sheet for the previous years; the tax is calculated on the profits provided for in the programme of activity. At the same time with the establishment of the provisionally calculated tax, the final tax on the previous year is established. The provisionally calculated tax liability for the current year is paid into the State budget in equal quarterly instalments payable at the end of each term. The tax differences established for the previous year are paid within 10 days from the date the fiscal bodies communication was received. The amounts paid in excess are transferred into the account for the current year or are returned upon request.

G. Example of calculation of the tax[4]

Below is an example calculation of the tax on profits of joint ventures established in Romania which illustrates the way in which the provisions of Decree No. 425/1972 are applied.

A joint venture was established in Romania between a Romanian partner and a foreign partner with a Romanian share of 51% and a foreign participation of 49%.

The equity capital amounted to 100,000 DM.

Net profits of 1980	10,000 DM
5% reserve fund deduction	(500) DM
Taxable profits	9,500 DM
Tax due (assuming full first-year exemption)	
After tax profits	9,500 DM
Available for distribution to the enterprise: 49% of 9,500	4,655 DM
Tax on profits transferable abroad: 10% of 4,655 (assuming distribution of all available profits)	(466) DM
Net profits transferred abroad	4,189 DM
Net profits of 1981	200,000 DM
5% reserve fund deduction	(10,000) DM
Taxable profits	190,000 DM
Tax due: 15% of 190,000 (assuming second-year one-half reduction)	28,500 DM
After tax profits	161,500 DM
Available for distribution to the enterprise: 49% of 161,500	79,135 DM
Tax on profits transferred abroad 10% of 79,135	(7,914) DM
Net profits transferred abroad	71,221 DM
Net profits of 1982	300,000 DM
5% reserve fund deduction	(15,000) DM
Nevertheless the reserve fund cannot exceed 25% of the invested capital; in our example, the limit of 25% of 100,000, i.e. 25,000	
Because the reserves created in 1980 and 1981 are 500 and 10,000, the reserve which can be created in 1982 is 25,000 - 10,500 (500 and 10,000) = 14,500	(14,500) DM
	285,500 DM
Taxable profits	
Tax due if 50,000 is reinvested: ½ of 30% of 235,000 . . . 35,250 4/5 of 15% out of 50,000 . . . 6,000	(41,250) DM
After tax profits	243,750 DM
Available for distribution to the enterprise: 49% out of [243,750 - (50,000-6,000)]	7,878 DM
Tax on net profits transferred abroad: 10% out of 98,086	(9,788) DM
Net profits transferred abroad	88,090 DM
Net profits of 1983	500,000 DM
Taxable profits (the limit on the amount of the reserve fund has been reached in previous years)	500,000 DM
Tax due if 250,000 is reinvested:	
30% of 250,000	75,000 DM
24% of 250,000	60,000 DM
	(135,000) DM
After profits	365,000 DM
Available for distribution to the enterprise: 49% of (365,000 - (250,000-60,000))	85,750 DM
Tax on transfer abroad: 10% of 85,750	(8,575) DM
Net profits transferred abroad	77,175 DM

H. Appeals

Pursuant to Decree 425/1972, joint ventures may file an appeal, in first instance, directly with the financial body which has established the differences in tax profits.

If found unsatisfactory by the joint venture, the decision of the financial body may be further appealed to the Ministry of Finance, where it will be considered by a Committee consisting of delegates from the Ministry of Finance, the Chamber of Commerce and Industry and presided over by a Supreme Court Judge. This second appeal represents an innovation for the Romanian socialist fiscal procedure, justified by the specific traits of the tax on profits of joint ventures with headquarters in Romania. This is a body for resolving appeals with a complex composition organized both by the participation of the fiscal hierarchical body (the delegate from the Ministry of Finance) and by the inclusion of Supreme Court judge and a delegate from a public organization specialized in the field of foreign trade.[5]

I. Sanctions

Any tax evasion will give rise to a sanction in the form of a fine equal to 25% of the undeclared tax. Any

4. This exchange is reproduced from Condor, I., *Guides to European Taxation – Vol. V., Taxation in European Socialist Countries*, Chapter Romania, at 103.

5. See Condor, I., Nicolescu, Gh., *Taxes and dues in Romania: Fiscal procedure*, Editura ştiinţifică şi enciclopedică, Bucharest, 1983, at 128 (in Romanian).

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delay in payment will give rise to an increase of 0.05% for each day of delay, but only up to a maximum amount of double tax due.

J. Repatriation of profits

After satisfaction of joint venture's tax liability the amount of profits distributed to co-partners are subject to an additional tax of 10%, if they are transferred abroad.

K. Registration due

Joint ventures are registered at the Ministry for Foreign Trade and the Ministry of Finance on the basis of the joint venture Contract and Statutes, approved in accordance with the terms of the law. The registration tax is 5,000 lei, paid in the foreign currency provided for in the Contract.

L. Fiscal incentives for foreign investment

From the legal rules and the example it appears that the Romanian tax regime applied to joint ventures established in Romania places upon them a normal tax burden, being a stimulating element for foreign investors in participating in such ventures.

It should be noted, at the same time, that foreign capital invested in Romania for operations admitted by Romanian legislation is not subject to a separate tax, so that the foreign co-partner firms have a particularly important incentive.

III. TAXATION OF NON-RESIDENTS

A. Definition of non-residents

The continuous development of economic, technical-scientific and cultural relations with other countries has required the appropriate regulation of the income obtained in Romania by non-residents.

Non-residents are regarded as natural persons who live outside the territory of Romania or who spend a period of time less than a total of 120 days per year within the territory of Romania, as well as local entities not having their permanent residence within Romania (Art. 1(1) of Decree 276/1973). This legal definition of non-residents ensures a precise determination of the taxable person.

General rules applied to non-residents

Under Romanian fiscal legislation the taxation of incomes and property is conducted without regard to whether the taxable person is a Romanian resident or an alien, applying the principle of non-discrimination which operates as an essential characteristic of Romanian fiscal policy. Thus, under Romanian law, the incomes obtained from Romanian sources by non-residents are in principle subject to taxation under the same conditions as for Romanian residents. Subject to this rule, for example, are incomes accruing to non-residents in the form of wages or in connection with literary, artistic and scientific activities (Decree 153/1954). The tax due may not exceed 60% in case of legal entities and 45% in case of natural persons. Thus, for example, the taxation of incomes accruing in the form of wages and in other forms of remuneration of employees and persons co-operating with joint ventures, is applied pursuant to legal provisions in force in Romania, i.e. in accordance with the general rules applicable to each fiscal liability (Art. 13(2) of Decree 425/1972).

However, effective 1 January 1974, a distinct tax was established with respect to certain incomes derived within the Socialist Republic of Romania by non-resident natural persons and legal entities (in accordance with Decree 276/1973)[6]. Any incomes other than those subject to separate taxation remain subject to tax pursuant to the legal rules on the taxation of the respective incomes, i.e. Decree 153/1954.

C. Special rules with respect to certain non-resident incomes

Certain incomes derived in Romania by non-resident natural and legal persons in connection with operations and activities involving Romanian organizations are subject to a tax at a proportional rate which is provided by Decree 276/1973. The tax is levied against incomes generated in Romania as well as incomes generated abroad, but derived from a source situated within Romania. The income categories subject to this special tax treatment are the following:

(a) 15% in connection with commercial loans, as well as commissions in connection with commercial transactions;
(b) 15% in case of income from:
  (aa) the rendering of certain technical or professional services including technical assistance, instruction and training of personnel, quantitative and qualitative product control, professional appraisals, scientific or technical consulting services, medical examinations, and a number of other services;
  (bb) shipping and air transport. The tax is levied only on the income of persons having their headquarters or residence in States which levy a tax on comparable income derived from those States by Romanian transport enterprises.

Income derived from within Romania by persons with headquarters or residence in States which levy against Romanian transport enterprises a rate less than 15% are subject to tax at this lower level;

(c) 20% for payments made in connection with the

6. Decree for regulating the taxation of incomes obtained by non-resident natural and juridical persons, published in the Official Gazette No. 70 of 16 May 1973, amended by Decree 125/1977.

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assignment or use of patents, inventions, licences, trade marks, know-how and other similar rights;

(d) 25% for payments made in the areas of entertainment and the performing arts, other than payments classifiable as a form of remuneration.

The rates of 15%, 20% and 25% are levied on payments by non-resident natural persons or legal entities on the taxable income which would result by the deduction from incomes of expenses effected for their acquisition.

The actual collection of the tax is accomplished by the Romanian party paying the income to the non-resident upon each transaction. The collected amount constitutes a final tax and is payable up until the 15th day of the month following that in which payment for the transaction was effected.

Tax exemptions or reductions for certain categories of incomes, or on a case-by-case basis, may be approved by a Council of Ministers' decision. It should be noted that in the case of countries with which Romania has concluded conventions regarding avoidance of double taxation the proposed facility is generally not beneficial to the foreign partner, but to the treasury of his country of residence.

The above described fiscal regime provided by Decree 276/1973 operates in conjunction with a number of corresponding provisions of Law concerning the taxation of the population's income. Thus a legal basis was created for the resolution of problems of a procedural nature connected with: the establishment of the tax liability, the application of the periods of statutory limitations, the liabilities and applicable sanctions, etc., in accordance with Decree 153/1954.

In cases where there exist conventions for the avoidance of double taxation[7] or other international agreements to which Romania is a party, the provisions of such conventions or agreements relating to the income tax will apply. Thus, for example, in the case of the Federal Republic of Germany the convention for the avoidance of double taxation concluded with this country in 1974 will apply.[8]

IV. TAXATION OF FOREIGN COMMERCIAL REPRESENTATIONS

A. The taxable foreign enterprise in general

In an effort to encourage the expansion and diversification of economic and financial relations with other countries, Romanian law provides that foreign individuals and legal entities may achieve the status of residents with respect to the taxation of income derived from the carrying out of certain activities within the territory of the Socialist Republic of Romania. Under the applicable Romanian legal provisions, foreign persons are permitted to attain such resident status either by conducting activities via a commercial representation or a foreign economic organization, or by acting as a co-partner in a joint venture. Once the legal prerequisites concerning the establishment, organization and operation of the commercial representation or the joint venture have been satisfied, the door is open for the application of the appropriate taxation regime, the provisions of which emphasize the necessity of facilitating international economic relations and the importance of the establishment of foreign commercial representations and foreign participation in joint ventures within Romania.

B. General rules applied to commercial representations

Representations of foreign commercial forms and economic organizations can function in Romania on the basis of an authorization given in accordance with Decree 15/1971 amended by Decrees 396/1973 and 243/1977.

The taxation of representations is effected pursuant to general rules governing the taxation of population income (Decree 153/1954 with the subsequent amendments) applying the tax rates established for incomes derived from activities performed on the person's own account. The tax rates cannot exceed 60% of the taxable income.[9]

The amount of taxable income will vary depending upon the manner in which the commercial representation derives its income.

In the case of representations whose income is generated via the payment of commission fees, either from the firms they represent or from the parties for whom they perform services, taxable income is determined by deducting operating expenses (including remunerations, contributions to social insurances, rent, telex and telephone costs, materials and supplies, etc.) from the total income.

However, if the taxable income so determined falls below the standard income level prescribed by the Ministry of Finance with respect to foreign commercial representations (each level being based upon the number of individuals employed by the representation), then the tax liability will be calculated in accordance with the standardized amounts, as follows:

Category of the foreign commercial representations	*Annual income standard (in lei)*
Type A – those having 1 or 2 employees	100,000
Type B – those having 3 to 5 employees	250,000
Type C – those having 6 to 8 employees	400,000
Type D – those having over 8 employees	800,000

7. Condor, I., *On the Avoidance of International Double Taxation*, in "Revista română de drept", 1979, No. 6, pp. 10-88 (in Romanian).
8. Weber, E., *Überblick über das deutsch-rumänische Doppelbesteuerungsabkommen*, IWB, No 12, 26 June 1975.
9. See Condor, I., Nicolescu, Gh., op. cit., p. 59 et seq.; Condor, I., *Guides to European Taxation, Vol. V, Taxation in European Socialist Countries*, Chapter Romania, at 85-86.

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C. The method of calculation and payment

During the first year of the representation's activities within Romania, the tax is provisionally established. In January of the following year, a definitive tax is imposed either on the actual income derived during the preceding year, or where necessary, on a fixed income.

D. Local taxes and uses

Non-residents must pay local taxes and dues provided by Law 25/1981 and Decree 425/1981, such as the tax on buildings, means of transportation, delivery of building permits in the areas of constructions, etc., to the extent to which it is not otherwise provided by international conventions or agreements to which Romania is a party or as a result of reciprocity.

E. Sanctions

Non-payment at the due date of taxes and dues gives rise to increased rates for delay calculated on the amounts which were not timely paid; the increased rate is 2% for each month of delay or fraction of a month.

F. Statutory limitation

Taxes and dues which are not determined in time are owed by non-resident natural persons and legal entities two years previous to the year in which this situation is established (Art. 32 of Decree 153/1954).

The right to demand a levy under distrain of taxes and dues falls under a statutory limitation of *5 years* for fiscal debts of non-resident natural and juridical persons (Art. 45(1) of Decree 221/1960, republished in 1969).

G. Tax on wages

Separately from the income tax and the local taxes and dues owed by representations, non-resident persons working for these entities owe, for remunerations received in this capacity, tax on wages as provided by Decree 153/1954, with subsequent amendments.

CONCLUSION

Romanian legislation provides a reasonable fiscal burden for joint ventures constituted within Romania and for non-resident natural and juridical persons which is likely to stimulate international economic and financial relations.

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Bureau of European Taxation and Trade, Att.: Ms. Audrey Evelyn Bone, 606 Bryer Court, Barbican, City of London, EC2Y 8DE, United Kingdom.

Institut für Auslandsbeziehungen, Referat für Informationsseminare, Charlottenplatz 17, 7000 Stuttgart 1, Federal Republic of Germany.

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H. Siebens:

Belgique: Quelques-uns des aspects particuliers des bénéfices et pertes de source étrangère en matière d'imposition du revenu des sociétés 391

L'auteur commente un certain nombre de problèmes importants dus à la relation existant entre une société belge et son établissement stable situé à l'étranger. Un ensemble de problèmes porte sur la détermination du revenu mondial de la société belge, tel que le traitement des pertes de source étrangère. Un second ensemble de problèmes est dû à la qualification de l'établissement stable en tant que contribuable distinct. D'une façon tout à fait inattendue, beaucoup de ces problèmes n'ont pas encore été résolus; les autorités fiscales belges ne se sont même pas encore prononcées pour certains d'entre eux.

J.Malherbe:

Belgique: Simulation, "fraus legis" et raisons professionnelles 396

Le concept légal de "simulation" peut-être utilisé par les autorités fiscales belges pour critiquer certaines transactions dont le premier motif est d'éviter l'imposition. Les concepts de "fraus legis" et de véritables raisons professionnelles ont, au contraire, été rarement, si ce n'est jamais, invoqués par les juridictions pour empêcher un contribuable de réduire sa charge fiscale. L'auteur pense qu'en introduisant de tels concepts on ouvre la porte aux erreurs et à l'arbitraire, créant ainsi une forme d'insécurité pour les contribuables.

Luc Hinnekens:

Belgique: Aspects internationaux de l'imposition sur la rémunération du cadre supérieur 400

Les dernières années, la pression fiscale en Belgique a augmenté de telle façon qu'à l'heure actuelle la Belgique fait partie des pays ayant des impôts les plus élevés. Toutefois, l'auteur démontre comment le cadre supérieur résidant en Belgique pourrait réduire le montant de l'impôt sous les mesures belges unilatérales et les dispositions des conventions fiscales. Dans certains cas "la route de Chypre" est une bonne solution, tandis que pour les ingénieurs et les techniciens postés dans des pays non-européens et qui n'ont pas conclu des conventions fiscales avec Belgique des dégrèvements spéciaux sont offerts par une lettre circulaire administrative. Le cadre supérieur étranger temporairement posté en Belgique peut profiter aussi des mesures diminuant le montant de l'impôt sous des instructions promulguées par le fisc belge.

J. Autenne:

Avantages fiscaux offerts en Belgique aux activités de recherche scientifique 407

La Belgique a conscience de l'importance de la recherche pour le développement de son économie, c'est pourquoi elle a introduit des avantages fiscaux particuliers qui viennent s'ajouter à l'aide qu'elle offrait déjà par l'intermédiaire de ses agences nationales et régionales. L'auteur décrit les avantages fiscaux les plus importants en tenant compte du fait qu'un contribuable peut choisir d'exercer son activité de recherche soit dans une organisation dejà existante, soit dans une société nouvellement créée.

Jacoba Helfrich-Laubrock:

Chambre de Commerce Internationale – Analyse du Projet de Convention de l'Assistance Administrative Mutuelle dans le Domaine Fiscal adopté par l'OCDE et le Conseil d'Europe 410

L'auteur signale la critique sévère de la Chambre de Commerce Internationale du Projet de Convention de l'Assistance Administrative Mutuelle dans le Domaine Fiscal récemment adopté par l'OCDE et le Conseil d'Europe. Elle termine en concluant qu'on n'a pas besoin d'une telle convention étendue et elle indique que le commerce et les investissements internationaux souffriront inévitablement de son application.

Nouvelles de l'IFA 413

Dr. Norbert Seeger:

Liechtenstein: Réforme fiscale 414

Le Liechtenstein a un système d'impôt général sur le capital complété par un petit impôt sur le revenu. Après un recensement de la population, il a été décidé récemment que l'impôt sur le revenu devrait avoir plus de poids dans ses effets. Les résultats de ce changement d'attitude sont commentés par le Dr. Seeger dans cet article.

und die Behandlung von Einkünften aus ausländischer Quelle. Der Artikel schliesst ab mit einer Untersuchung zu Fragen der indirekten Steuern und dem formellen Steuerrecht.

H. Siebens:

Belgien: Betrachtung spezieller Aspekte der Behandlung der Gewinne und Verluste ausländischen Ursprungs bei der Körperschaftsteuer 391

Der Verfasser untersucht eine Reihe von wichtigen Problemen im Zusammenhang mit dem Verhältnis belgische Gesellschaft-ausländische Betriebstätte. Eine Problemgruppe betrifft die Bestimmung der weltweiten Einkünfte einer belgischen Gesellschaft, wie z.B. die Behandlung von Verlusten ausländischen Ursprungs. Eine zweite Problemgruppe entsteht durch die Qualifizierung einer Betriebstätte als selbständige Steuerpflichtige. Es dürfte überraschen, dass viele dieser Probleme noch nicht gelöst sind und dass in manchen Fällen die belgischen Steuerbehörden bislang noch keine Meinung zu den entsprechenden Sachverhalten verlauten liessen.

J. Malherbe:

Belgien: Scheingeschäfte, fraus legis und der Geschäftszweck 396

Das Rechtsinstitut des "Scheingeschäfts" kann von den belgischen Steuerbehörden dafür genutzt werden, bestimmte Transaktionen anzugreifen, deren hauptsächlicher Zweck in der Steuervermeidung besteht. Im Gegensatz dazu werden die "fraus legis" und der Begriff des (tatsächlichen) Geschäftszweckes kaum, wenn überhaupt, von den belgischen Gerichten angewandt, wenn es darum geht, einen Steuerpflichtigen von der Minimierung der Steuerbelastung abzuhalten. Der Verfasser vertritt die Auffassung, dass die Einführung eines solchen Instruments die Tür für Irrtümer und Willkürlichkeiten öffne und dass sie Unsicherheiten für die Steuerpflichtigen schaffen würde.

Luc Hinnekens:

Belgien: Internationale Aspekte der Besteuerung von Vergütungen an leitende Mitarbeiter 400

Die Steuerbelastung in Belgien stieg in den letzten Jahren in einem solchen Masse an, dass Belgien zwischenzeitlich zu den Ländern mit den höchsten Steuern gehört. Der Verfasser zeigt allerdings auf, dass leitende Mitarbeiter, die in Belgien ansässig sind, ihre Steuerlast wesentlich verringern können, und zwar durch die einseitigen Massnahmen zur Vermeidung der Doppelbesteuerung in Belgien, bzw. durch die belgischen Doppelbesteuerungsabkommen. In bestimmten Fällen kann auch die Einkommenszahlung via Zypern eine gute Lösung darstellen, während für belgische Ingenieure und Techniker, die in aussereuropäischen Ländern tätig sind, mit denen kein Doppelbesteuerungsabkommen besteht, eine Verwaltungsanweisung eine günstige steuerliche Behandlung bewerkstelligt. Ausländische leitende Mitarbeiter, die zeitweilig in Belgien stationiert sind, können ebenfalls von Richtlinien der belgischen Steuerverwaltung profitieren, die eine für sie vorteilhafte Besteuerung ermöglichen.

J. Autenne:

Steuerliche Förderungsmassnahmen für wissenschaftliche Forschungsaktivitäten in Belgien 407

Belgien ist sich der Wichtigkeit der Forschung für die Entwicklung seiner Wirtschaft wohl bewusst und führte aus diesem Grund spezifische Steueranreize ein, die zusätzlich zu den bereits durch die nationalen und regionalen Körperschaften gewährten Hilfen gegeben werden. Der Verfasser beschreibt die wichtigsten dieser Fördermassnahmen, wobei er darauf hinweist, dass der Steuerpflichtige wählen kann zwischen der Durchführung von Forschungsaktivitäten in einem bestehenden Unternehmen und einer neugegründeten Gesellschaft.

Jacoba Helfrich-Laubrock:

Die Internationale Handelskammer (ICC): Kritische Anmerkungen zum multilateralen Europarat/OECD-Konventionsentwurf zur steuerlichen Rechts- und Amtshilfe 410

Die Verfasserin erläutert die nachhaltige Kritik der Internationalen Handelskammer zum multilateralen Europarat/OECD-Konventionsentwurf zur steuerlichen Rechts- und Amtshilfe, der kürzlich von der OECD und vom Europarat angenommen wurde. Sie kommt zu dem Schluss, dass für ein derart weitreichendes Abkommen eine Notwendigkeit nicht besteht; ferner weist sie darauf hin, dass Handel und Investitionen im internationalen Rahmen unter der Anwendung dieses Abkommens zweifellos leiden werden.

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Har Govind:

Inde: Le traitement fiscal des paiements suivant les conventions de coopération avec l'étranger 420
La croissance continue de conventions de coopération a mené à de nombreux conflits entre le département d'impôt sur le revenu indien et les parties contractantes. La terminologie des conventions pourrait avoir des conséquences fiscales. L'auteur analyse les problèmes et présente la position des courts relativement aux conventions de coopération.

Lars-Erik Wenehed:

Les impôts et l'ordinateur 426
M. Wenehed explique le système informatique COMPTAX et éclaire les possibilités de planifier les impôts à l'aide des programmes COMPTAX.

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Dr. Norbert Seeger:

Liechtenstein: Die Steuerreform 414
Liechtenstein kennt ein System einer allgemeinen Vermögensteuer, die durch eine qua Aufkommen geringfügige Einkommensteuer ergänzt wird. Es wurde kürzlich beschlossen, dass die Einkommensteuer in Zukunft eine bedeutendere Rolle spielen soll. Die Ergebnisse dieser Änderung, die in der Verschiebung der Gewichte dokumentiert wird, werden von Dr. Seeger erläutert.

Har Govind:

Indien: Die steuerliche Behandlung von Zahlungen im Zusammenhang mit Vereinbarungen über Zusammenarbeit 420
Die ständige Zunahme der Vereinbarungen über Zusammenarbeit hat zu zahlreichen Rechtsstreitigkeiten zwischen der indischen Einkommensteuerbehörde und den Vertragsparteien geführt. Die in den Vereinbarungen aufgenommenen Begriffe können Auswirkungen auf die steuerliche Behandlung haben. Der Verfasser erläutert die Probleme und stellt die Auffassung der Gerichte bezüglich der Vereinbarungen über Zusammenarbeit dar.

Lars-Erik Wenehed:

Steuern und Computer 426
Herr Wenehed stellt das Computersystem COMPTAX vor und erläutert die Möglichkeiten der Steuerplanung mittels der COMPTAX-Programme.

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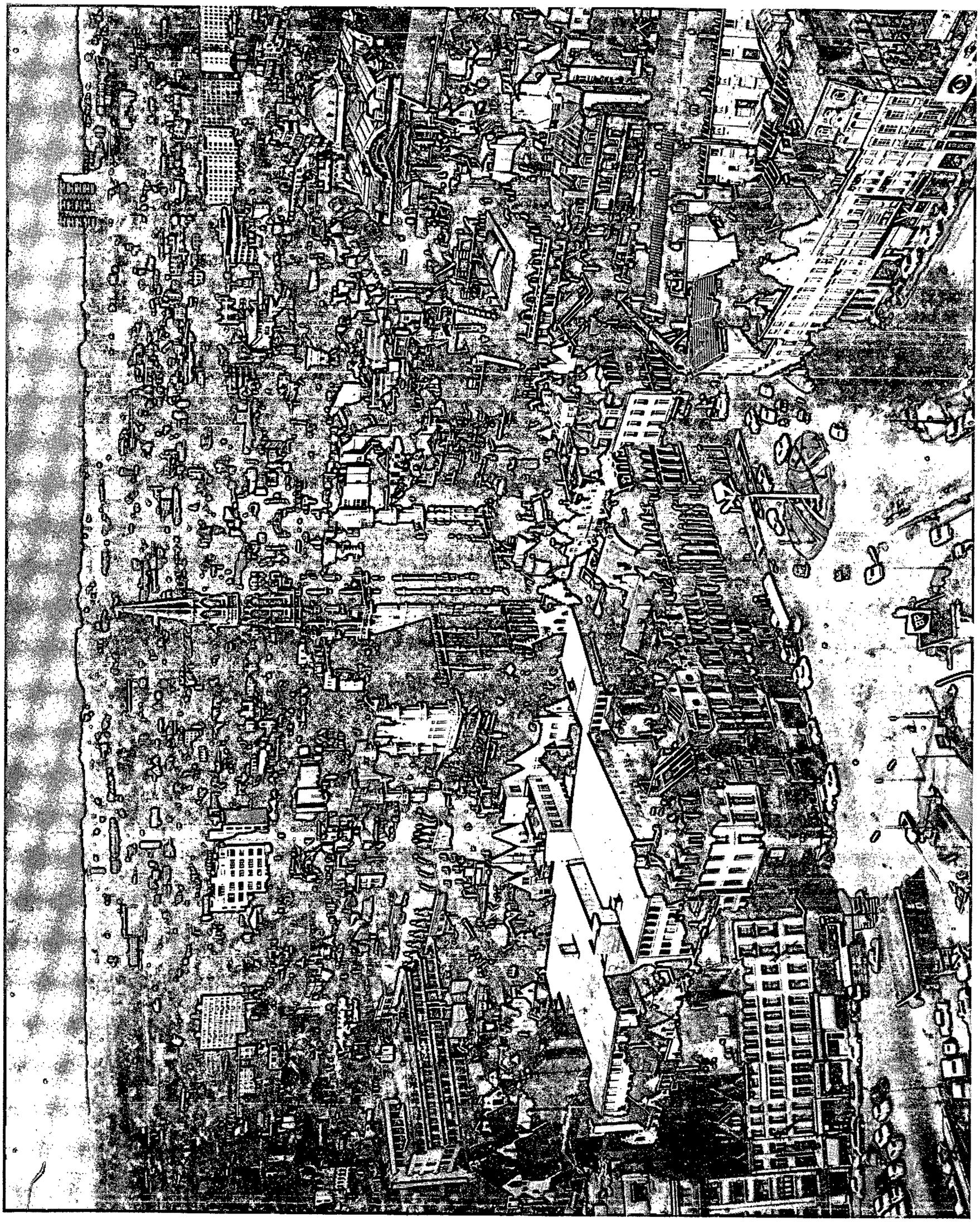

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Brussels: Site of the Grand' Place

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Brussels Congress 1987

RICHARD M. HAMMER

President of IFA

IFA returns to the Continent for the first time since the Venice Congress in 1983. Like Venice, Brussels is small by IFA standards. And, also like Venice, it is steeped in history, art and culture, and is renowned for its food. But Brussels promises to be a more convenient venue, with metro service to its new, state-of-the-art, conference center (although I hope there are no IFA members who believe that Venice would be improved by a metro). Incidently, this is the fourth time an IFA Congress has been in Belgium – which ties the record for Congresses in one country.

Brussels is a complete change of pace from New York, which is in a class by itself in hustle, bustle, and diversity. The Monday night reception in Brussels at the Museum of Fine Arts follows very successful receptions of the two previous Congresses at the British Museum and the Metropolitan Museum of Art. The former, with cocktails by the Rosetta stone, was unique and something to remember; while the latter was on a particularly breathtaking scale through the taste and generosity of Met board member and IFA member Tatiana Copeland.

The Brussels excursions promise a treasure trove of art and architecture from medieval times to the present. Many will regret not being able to go on all of them (although, as always, a few will prefer golf to culture).

The technical subjects for discussion at the Brussels Congress are timely. Subject I, "the fiscal residence of companies", closely follows recent legislative initiatives in the United States, Australia, the United Kingdom, and New Zealand that takes the benefit out of using dual-resident companies for cross-border investment by multinational groups. The industrial countries' criteria for corporate residence vary widely, involving such as (1) place of management and control, (2) place of incorporation, (3) location of ownership and (4) combinations of these criteria. A long-term goal should be standard criteria that are sensible, objective, and easily understood.

Place of "management and control", the standard used in the U.K. and many other Common Law countries, made sense in the day of sailing ships, but with jet travel corporate residence (i.e., where the board of directors meets) can easily be manipulated. For several years the U.K. Government has seemed on the verge of a statutory definition of corporate residency, so change is in the wind.

And the United States, which ostensibly ties corporate residence to place of incorporation, has in fact substituted many elements of a substance and/or ownership and control test. For example, Subpart F generally does not apply where a subsidiary is engaged in business in its country of incorporation; the "treaty shopping" provisions of Article 16 of the U.S. model income tax treaty do not apply if the corporation has local substance and/or local ownership; the new FSC legislation requires that the "foreign sales corporation" have a degree of local (foreign) management and control; and the relatively new anti-stapled stock provisions were amended (retroactively) to provide that they do not apply if the U.S. and foreign corporations are "foreign owned".

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).

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These and other de facto modifications of the U.S.'s corporate residency rules account for much of the mind-numbing complexity of its tax laws.

Subject II, "tax treatment of the liquidation of corporations", also considers an area in need of rationalization. In the United States, for example, a parent company gets no tax loss on the liquidation of a subsidiary unless the subsidiary is totally worthless. Thus the deduction of, say, a $ 100,000,000 can be at stake where the issue is whether a piece of real estate is worth (1) $ 100,000 or (2) $ 110,000. Hardly a tax policy that makes sense.

Seminar A considers "taxation and human rights". The topic essentially is limited to the rights of taxpayers during tax examinations by the authorities, but I hope that there is time for comments on other areas that fall within the scope of the title. Human rights is a high visibility subject in view of the tax treaties that have been terminated with South Africa. Also, vestiges of sexism remain in some tax systems, and the United States even attacks the institution of marriage by taxing a married couple more harshly than it would two single people making the same income.

Seminar B is titled "effectiveness of current competent authority procedures for relief of international double taxation: future developments". This considers double taxation relief from a different perspective than did the 1981 Congress in Berlin. Unfortunately, competent authority, as implemented by most countries, has not yet fulfilled its almost unlimited upside potential as a medium for mitigating double taxation. IFA must continue to make it high priority that competent authority procedures become timely and affordable and reach fair results. Certainly the opposite, in all respects, is closer to the current norm.

Seminar C continues the practice of looking at the tax systems of the countries of the host branch. The seminar considers (1) Belgian coordination centers and (2) Luxembourg (a) investment funds and the EEC Directive on UCITS and (b) reinsurance. These topics are timely because of the worldwide trend of smaller developed countries to offer very attractive incentives to multinationals to locate high-value non-pollutive functions such as area headquarters, R&D facilities, fund management, cash management, and captive insurance operations. Both Belgium and Luxembourg have developed attractive niches for themselves in this competition.

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 Belgian Branch and, in particular, the organizing committee for orchestrating what promises to be an exciting and great Congress.

Conference Diary

AUGUST 1987

Public Finance and the Performance of Enterprises; 43rd Congress and Semicentennial of the IIPF. Paris, 24-28 August (English/French; working groups mainly English):
International Institute of Public Finance, Secrétariat Général, Université Paris II – Panthéon, 12, place du Panthéon, F 75231 Paris Cédex 05, France.

SEPTEMBER 1987

The Fiscal Residence of Companies; Tax Problems of the Liquidation of Companies; Taxes and Human Rights (Seminar). Brussels, 6-11 September (English, French, German, Spanish):
International Fiscal Association, General Secretariat, P.O. Box 1738, 3000 DR Rotterdam, Netherlands.

National Tax Developments, Taxes and High Tech Operations, Taxes and International Venture Operations, the Issue of International Securities. London, 14-18 September (English):
International Bar Association, Section on business law, 2 Harewood Place, Hanover Square, London W1R 9HB, United Kingdom.

Tax Warranties and Indemnities on Company Acquisitions. London, 15 September (English):
European Study Conferences Ltd., the Registrar, Douglas House, Queen's Square, Corby, Northants NN17 IPL, United Kingdom.

VAT and Charities. London, 17 September (English):
European Study Conferences Ltd., the Registrar, Douglas House, Queen's Square, Corby, Northants NN17 IPL, United Kingdom.

Change or Residence: Individuals; Monte Carlo Workshop. Monte Carlo, 17-18 September (English):
International Tax Planning Association, Att. Elizabeth Walters, I.T.P.A. Membership and Conference Liaison Office, 33A Warwick Square, London SW1V 2AQ, United Kingdom.

Fourth Annual: Structuring Partnership Agreements. Los Angeles, 17-18 September (English):
Prentice Hall Law & Business, 855 Valley Road, Clifton, NJ 07013, U.S.A.

U.S. Corporate Taxation: advanced subjects (a one-week intensive course). Lésigny, 21-26 September (English):
The American Tax Institute in Europe, 14, rue Jean Mermoz, 75008 Paris, France.

Symposium on the Taxation of Directorship in Europe. London, 28 September 1987 (English):
Bureau of European Taxation and Trade, Att.: Ms. Audrey Evelyn Bone, 606 Bryer Court, Barbican , City of London, EC2Y 8DE, United Kingdom.

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Taxation in Belgium

Recent Measures and Future Prospects

By Mark Eyskens, Minister of Finance

MACRO-ECONOMIC CONTEXT

As Belgium is a typical case of a small, open economy, our economic conditions have always been strongly dependent upon the international environment.

In the second half of the seventies Belgium learned the harsh lesson of moving out of line with the economies of our main trading partners. Since the beginning of the eighties all our policy efforts have been directed towards restoring economic convergence, in particular with other countries within the European Community, as we depend for nearly 70% of our export on other EC countries.

Since a multidimensional package of adjustment measures has been formulated at the depth of the recession in Belgium nearly five years ago, the economic situation has been gradually improving, without, however, being able to solve all economic problems at once.

Although Belgium is moving in the right direction, there are still many structural rigidities that should be overcome. The economic recovery should be further sustained by setting policies on a two-track course: continuing our macro-economic adjustment policies together with medium term structural adjustments.

Within this medium term strategy, fiscal policies have a major role to play. In the short run our budgetary problems may be mainly a question of deficit reduction. In a medium term context, however, they are as much a question of the structure of Government expenditures and Government receipts, and therefore a problem of structural adjustment.

The growing burden of interest payments on public debt and the financing of large scale economic and social transfers in Belgium, has resulted in a further increase in the already high tax pressure. Between 1965 and 1985 Belgium, together with Denmark, has known the most extensive increase in taxes of all OECD countries. In 1985 we ranked fourth on the list of high tax OECD Member States, only preceded by Sweden, Denmark and Norway. The total tax burden, including payroll taxes, amounts to nearly 47% of GNP.

At the micro-economic level the high (confiscatory) marginal tax rates have resulted in excessively large differentials between wage costs and take-home pay. It has made our efforts to improve the competitiveness and the profitability of our business firms all the more difficult. Also the psychological disincentive effects and the high tax burden on labor are counter-productive in remedying the unemployment problem.

Apart from the structural rigidities induced by fiscal distortions at the domestic level, fiscal reforms in Belgium may become a necessity just to maintain our competitiveness in the world economy. It is needless to say that tax reforms in the United States appear to have important spill-over effects in the rest of the world.

Besides the United States, several other countries are also preparing or have promulgated new tax laws that provide for substantial tax cuts. Mid-February of this year, six major countries, in view of stabilizing the exchange rates ("Louvre Agreement"), have subscribed to the policy to continue their efforts for fundamental tax reforms in order to improve incentives, increase the efficiency of economies, and enhance the prospects of higher growth.

Dr. Mark Eyskens (age 54) received his Baccalaureate in Philosophy, Doctorate in Economics and Doctorate in Laws from the Catholic University of Louvain. He also received a Master of Arts in Economics from Columbia University, New York.

After completing his studies he became active in Government. Dr. Eyskens was a member of the Trilateral Commission (Europe-U.S.A.-Japan) from 1973-1977. Since 1977 he has been a member of Parliament representing the district of Louvain. He was an editor for the monthly magazine *Knack* from 1972-1976.

Dr. Eyskens has held various ministerial positions including: Minister of Finance, Minister of Economic Affairs and First Minister. Since November 1985 he has been the Minister of Finance for the Martens Government.

Beside his Government obligations, Dr. Eyskens continues to write for various publications and is a Professor for Applied Economic Sciences at the Catholic University of Louvain.

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These competitive tax cuts abroad are a new challenge for smaller countries and are an extra incentive to go ahead with our own tax reform without any further delays.

RECENT TAX MEASURES

Of course, in the meantime the Government has already taken action in reducing the corporate tax rate from 45% to 43% and in working out some special tax schemes in the areas of investment, industrial adjustment and employment (such as the T-zones legislation).

The Coordination Center legislation, known as Royal Decree No. 187, which permits multinational groups to carry out a large variety of financial and management services on a very low tax basis, has proven to be a tremendous success. Well over 150 international companies have applied for permission to set up coordination centers and more than 140 of these applications have already been approved.

Further, tax deductions for investments by companies have recently been increased: in particular tax deductions for research and development. To promote risk capital investments in advanced technology, a new scheme of Venture Capital Funds has been set up.

The Government developed special tax schemes to facilitate "management buy-out" operations. To provide more incentives for employees and indirectly restructuring labor costs, the Government has worked out several schemes for employee profit sharing. Already quite well known are the "stock options" and the "permanent Monory".

Finally, the Government introduced savings pensions schemes, or as we prefer to call it "Third age saving". This measure is a tremendous success and has caused over 800,000 taxpayers to invest almost 17 billion Bfrs. in special accounts or insurance funds, allowing each participant to deduct up to 20,000 Bfrs. from its taxable income.

However, all these more specific tax measures that are geared to the more immediate needs, do not obviate the need for a more widespread tax reform.

TAX REFORM

I want to emphasize that as a major instrument of structural adjustment, fiscal reform should be put into a proper medium term framework and may not be carried out in an improvisatory ad hoc way. The compelling need to further reduce the Budget deficit in the near future does not leave us much room to manoeuvre. It is obvious that room for tax cuts should be created without raising the deficit. The policy of reducing bracket creep on personal taxation, that was introduced in 1985, was a step in that direction.

Moreover, experience has taught us that high tax rates do not automatically involve more total tax receipts for the Government. High tax rates reduce the tax base by creating incentives for tax evasion, tax avoidance and other such opportunities. Especially in such a small, open economy as Belgium, there is the real danger that tax inspired behavior is beginning to dominate economic justified behavior. In this respect, a reform aiming at simplifying our unduly complicated tax system, broadening the tax base and reducing tax rates, provides better prospects.

To work out concrete proposals, I have installed a Royal Commission for reforming and simplifying the tax system.

After studying the Belgian tax system for more than a year, the Commission presented its recommendations to the Belgian Government last February. The Commission proposes that the Government reduce the number of income tax rates from 14 to 4: 30%, 40%, 50%, and a top marginal rate of 60% for taxable income above 1,500,000 Bfrs. The Commission recommends that the total income tax a citizen pays never exceed 50% of his income.

In order to end the discrimination of married people under the present system, the Commission proposes to tax married persons separately without any limitation, instead of globalizing the family income as soon as it reaches a certain level. For families with only one income, this income should be divided between the two partners on a 70/30 basis and each part should be taxed in its own bracket. Also two-income families might opt for this system.

Further, the Commission recommends a rise in basic tax allowances to 150,000 Bfrs. for single people and 225,000 Bfrs. for married people. Child allowances should be raised, according to the Commission's report, to 45,000 Bfrs. for each of the first two children and 112,500 Bfrs. for each additional child.

The Commission proposes to globalize all income, irrespective of its source. However, for dividends paid, a 100% tax credit, equal to the corporate tax paid, would be allowed. There would be one important exception. Interest on capital which is not at risk would not be globalized, but taxed at a flat rate of 25%.

The report of the Commission provides for a maximum deduction of 50,000 Bfrs. for each taxpayer for all kinds of saving and investment schemes, as there are life-insurance, interest on mortgage loans, pension savings, etc.

For companies, I wish to highlight the following proposals:

- There should be an unlimited carry-forward of losses, but no carry-back.
- The full tax credit for dividends should also apply for dividend payments between related companies.
- The existing systems for coordination centers, T-zones, reconversion and innovation companies should be harmonized, and
- The increased tax deductions for investments by companies should be maintained.

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The Commission insists that its proposals to cut income taxes should be compensated for by raising excise duties on tobacco, alcohol, and petroleum products. It also proposes to abolish certain corporate tax deductions, the most important being the deduction for "extra-legal" insurances. Pensions, unemployment and other similar payments would also be taxed differently.

FUTURE PROSPECTS

The Commission's detailed report has been analyzed and studied and will be an important tool in drafting the legislative proposals which I hope to introduce in Parliament in October or November of this year. The reform should be enacted before the end of 1988.

This operation should be framed within a more general effort at the European Community level to remove fiscal and financial barriers, which should be done by harmonizing value added and excise taxes, and by eliminating distortions caused by differences in corporate and capital revenue taxes.

Due to the Budget deficit there is not much room at this time for an overall tax cut in Belgium. A real reduction of the tax pressure, however, should be possible in the near future. In view of the international evolution and as a small country, with a very large open economy sector, Belgium should not wait any longer. Our complicated tax system must be simplified and its competitiveness improved without further delays.

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BELGIUM:

Coordination Centers*

By Jean-Pierre Lagae

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Professor Jean-Pierre Lagae is an attorney with the firm of De Bandt, van Hecke & Lagae, Brussels, Belgium. Since 1972 he has taught at the Catholic University of Louvain. After receiving his Doctor of Laws diploma in 1956 from the University of Ghent, Professor Lagae studied for his Master of Laws (1958) and Doctor of Juridical Science (1962) at Harvard Law School. In 1986 he became a member of the High Council for Finance (Hoge Raad voor Financiën). He is a noted author who has been published in several languages and in many periodicals.

I. GENERAL

A. Introductory comments

The Belgian coordination center legislation, i.e. Royal Decree No. 187 of 30 December 1982[1], may be considered as a new and to some extent unique legislation which apparently meets the requirements of the large multinational companies. Indeed, some 150 multinational companies have decided to take advantage of this legislation.[2]

The main appeal of the coordination center legislation is that it allows the carrying on of not only administrative and other support services, but also, and most importantly, of a broad range of financial activities in an almost tax-free environment and outside the scope of the exchange control regulations.

The coordination center legislation was conceived as a tax incentive legislation. The coordination centers are taxed on a notional income and not on their real income. This notional income is fixed at a percentage of some of their expenses (i.e. expenses not including personnel costs and financial charges). In addition, interest and royalties paid and dividends distributed by coordination centers are not subject to Belgian withholding tax. Coordination centers can receive and pay or distribute income without paying almost any Belgian income tax.

Another important attraction of the coordination center legislation, at least for the multinational companies which plan to invest or to carry on R & D activities in Belgium, is the benefit of fictitious withholding tax, which has the same effect as an interest subsidy.

* This article was prepared with the assistance of Mr. Paul Tulcinsky, avocat, De Bandt, van Hecke & Lagae, Brussels.

1. The coordination centers which are being discussed in this article are the ones which qualify as such under Royal Decree No. 187 of 30 December 1982. It does not deal with the coordination centers qualifying for other preferential regimes under the double taxation treaties or administrative regulations or rulings.
For a complete list of statutory provisions governing the Royal Decree No. 187 coordination centers, see I., C. This article analyzes the legislation which is applicable to all qualifying coordination centers as from the assessment year 1988 on.

2. A copy of the published list of the multinationals who have been authorized to set up a Royal Decree No. 187 coordination center is reproduced as exhibit 1 to this article.

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B. Main characteristics

To grasp the coordination center legislation and to better understand its uniqueness, it might be helpful to state the reasons for introducing this tax incentive legislation in 1982.

The Royal Decree No. 187 on coordination centers is one of several important tax incentive measures which were enacted in 1982 to promote investment and employment in Belgium. It was intended to encourage the establishment of headquarter or coordination offices for large multinational companies. Brussels has traditionally been a forum for setting up headquarter offices. However, in the late seventies and early eighties Brussels experienced a loss in much of its attractiveness. The number of headquarter offices being formed in Brussels tended to remain unchanged, if not to diminish. One of the reasons was that Belgium's tax regime was no longer adquate.

The main concerns of the drafters of the Royal Decree No. 187 were the following:

(i) Enlarge the concept of tax-exempt "coordination center" contained in the double taxation treaties

Art. 5, para. 4, e) of the 1977 OECD Draft Double Taxation Treaty provides that "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" will not be deemed to be a permanent establishment. By application of this provision headquarter offices were not deemed to be permanent establishments provided they were formed as branches of foreign companies with residence in a treaty country and provided their activities were of a preparatory or auxiliary nature and exclusively for the nonresident enterprise itself.

The coordination center decree has enlarged the traditional concept of headquarter offices by broadening the category of activities which may be carried on by the coordination center and by providing that activities may be carried on for the benefit of the members of the group and not only for the enterprise itself[3].

A Royal Decree No. 187 coordination center may carry on activities such as financing, insurance and reinsurance activities which normally are not considered as being preparatory or auxiliary activities. A coordination center may, however, not carry on any real commercial activity. A new category of activities has been created which lies between the traditional preparatory and auxiliary activities and the commercial activities. A coordination center may carry on the traditional preparatory and auxiliary activities as well as this new category of activities.

A coordination center may engage in such activities for the members of the group to which it belongs, while under the double taxation treaties a center is only allowed to carry on activities for the enterprise of which it is a part. It should be noted in this respect that a Royal Decree No. 187 coordination center may be set up not only as a branch of a nonresident company but also as a local Belgian subsidiary.[4]

(ii) The creation of new jobs

One of the main concerns of the Belgian Government is the high rate of unemployment. The justification for this tax incentive measure was the creation of new jobs[5]. The preferential tax treatment is only granted if the coordination center has at least ten employees after a two-year start-up period. This employment requirement is taken very seriously and interpreted very strictly. A "brass plate" company cannot qualify as a Royal Decree No. 187 coordination center.

(iii) Cost reduction

Coordination centers are as a rule set up to reduce the cost of some activities of the group, essentially by avoiding duplications. They are cost reduction centers and not profit centers.

The drafters of the Royal Decree No. 187 were well aware of the fact that in view of the preferential tax treatment granted to coordination centers, certain enterprises might be tempted to transfer or shift profits from the operating companies to the coordination center[6]. Therefore the preferential tax treatment is not granted to the profits which are being transferred or shifted to the coordination center[7]. Such profits are subject to the regular company tax.

C. Legislation

Royal Decree No. 187 of 30 December 1982[8] is the original legislation containing the basic rules regarding coordination centers (conditions of eligibility, exemption from company tax, social law benefits). It has been amended by the Laws of 27 December 1984[9] and 4 August 1986[10] and implemented by Royal Decree of 3 November 1986[11].

Article 29 of the Law of 11 April 1983[12] (as amended by the Laws of 28 December 1983[13], 27 December 1984[14] and 4 August 1986[15]) has provided for some additional tax benefits to the coordination centers, including the exemption from withholding tax for interest, dividends and royalties paid or distributed by the coordination center and the benefit of the fictitious withholding tax.

The enumeration of the statutory provisions reveals that the coordination center legislation has been

3. Royal Decree No. 187, 30 December 1982, Report to the King, Official State Gazette, 1983, at 502.
4. Art. 1, Royal Decree No. 187.
5. Royal Decree No. 187, Report to the King, Official State Gazette, 1983, at 503.
6. Ibidem.
7. Art. 5, para. 1, Royal Decree No. 187.
8. Official State Gazette of 13 January 1983.
9. Official State Gazette of 29 December 1984.
10. Official State Gazette of 20 August 1986.
11. Official State Gazette of 20 November 1986.
12. Official State Gazette of 16 April 1983.
13. Official State Gazette of 30 December 1983.
14. See note 9.
15. See note 10.

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amended several times since the enactment of Royal Decree No. 187. Some of the amendments have been adopted under the pressure of the EC Commission which was of the opinion that the company tax exemption granted to coordination centers was contrary to Arts. 92-93 of the EEC Treaty[16]. Other amendments have restricted the scope of application of the fictitious withholding tax in order to eliminate some possibilities of abuse. Finally, a third category of amendments was intended to improve the system and to eliminate some deficiencies as evidenced by the application of the original legislation during the first few years.

The Central Income Tax Administration has until now not issued guidelines with regard to coordination centers[17]. The VAT, Registration and Domain Administration has done so as far as the exemption from registration tax on capital contributions is concerned[18].

II. QUALIFYING ACTIVITIES OF COORDINATION CENTERS

The activities a Royal Decree No. 187 coordination center may carry on include a large range of administrative and other support activities as well as financing activities. Such activities may only be carried on for the benefit of members of the group.

A. Intra-muros activities

The coordination center may only render services to other members of the group ("intra-muros" requirement)[19]. It is, however, not required that the coordination center should render services to all members of the group.

As mentioned above, the so-called group requirement is an essential feature of the coordination center legislation. It broadens the headquarters concept contained in the double taxation treaties which require that the coordination center performs services only for the headoffice and branches of the company of which it is a part.

The group requirement only relates to services performed by the center. It does not mean that the center is prohibited from having any contracts with third parties. It may, for instance, assist group members in the negotiation of sales contracts or in the collection of claims. For the purpose of its own activities, the center may be supplied by unrelated companies. A coordination center is equally authorized to borrow funds from third parties.

B. Type of activities

Royal Decree No. 187 enumerates the activities that can be engaged in by a coordination center. As mentioned earlier, these activities are much broader than those which are listed under the so-called tax-free coordination branches[20].

Most of the coordination centers have focused their activities in two primary directions: (i) support services activities and (ii) financing activities. Some specific problems arise as to insurance and reinsurance activities.

1. Administrative and other support services activities

This category includes a broad range of support services rendered directly to the group members to which they are normally charged on a "cost-plus" basis.

The centralization of such support services permits the avoidance of unnecessary duplication as well as increased efficiency.

Activities which fall within this category include the following:

- Advertising;
- Collection and dissemination of information;
- Relations with national and international authorities;
- Centralization of accounting, administration and data processing; the center could function as the group's EDP center for data processing, storage and transmission to and from group members;
- Advice and assistance on tax and legal matters;
- All activities having a preparatory or auxiliary character for the companies of the group.

Financial activities

The centralization of financial operations and the hedging of risks resulting from fluctuations in foreign exchange has specifically been provided for in Art. 1 of Royal Decree No. 187. This category of activities is one of the main features of the coordination center legislation and has been the primary focus of interest for multinationals as it enables financing operations to be carried out in a favorable tax climate.

To carry on these financing activities, coordination centers may use their own equity or funds borrowed from financial institutions or affiliated companies.

Coordination centers may raise funds by issuing notes and bonds under the following conditions[21]:

(1) Notes and bonds with an up to one-year maturity date. No restrictions are provided for.
(2) Bonds and notes with an over one-year maturity date.

The issuance of such bonds and notes is in principle

16. Notice of the EC Commission, Official Journal, C.104 of 2 May 1986, at 3.
17. This article has been drafted in April 1987.
18. Administrative Circular No. 6 of 12 April 1985.
19. The concept of "group" is defined hereafter.
20. Art. 5, para. 4, e), of the OECD Draft Double Taxation Treaty.
21. Such restrictions are applicable from assessment year 1987 onwards, i.e. income year 1986 for coordination centers which keep their accounts on a calendar year basis.

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forbidden. It can be authorized, however, by Royal Decree[22] provided:

(1) the bonds and notes are offered outside Belgium;
(2) they are issued in a currency other than the Belgian franc;
(3) assurances are given that the bonds and notes will not be acquired directly or indirectly by Belgian resident taxpayers other than Belgian companies.

Because an exemption from withholding tax is granted to interest paid by coordination centers to their lenders, bonds issued by coordination centers would have a competitive advantage over bonds issued by the Belgian State and other public authorities which are not exempt from withholding tax. Hence, the above restrictions have been imposed in order to protect the competitive position of State bonds within the Belgian capital market.

The main techniques used to achieve the centralization of financial operations and hedging of exchange risks are the following.

(a) *Intra-group lending*

Coordination centers may lend funds to affiliated companies on a short or long-term basis.

(b) *Leasing*

A Belgian coordination center may lease movable and immovable property to affiliated companies. This property can be purchased by the center from a nonaffiliated company. It cannot, however, be leased by the center and subleased to an affiliated company.[23]

A coordination center can even carry out sale and lease back operations with an affiliated company subject to the following restrictions:

(1) the goods sold and leased back should be new;
(2) the seller of the goods should not realize any capital gain on the sale to the coordination center.

(c) *Reinvoicing*

Reinvoicing to some group members of products and services invoiced to the center by other group members is one of the techniques used mainly to reduce or centralize foreign exchange risks. Reinvoicing supposes that no commercial gain, other than a small margin justified by the financing costs or foreign exchange risks, is realized by the coordination center in the operation.

(d) *Factoring*

Coordination centers may purchase from affiliated companies accounts receivable due from related and unrelated customers.

The main objectives of factoring operations are the financing of sales and the elimination of foreign exchange exposure of the affiliated companies. This can be achieved by causing the coordination center to make immediate payment in the currency of the selling affiliated company transferring its receivables.

(e) *Other financial services*

- placing of excess liquidity of group members with financial institutions;
- monitoring of bank accounts;
- collection of claims and payment in the name and for the account of the group members; etc.

3. Insurance and reinsurance

Insurance and reinsurance are explicitly listed as qualifying activities. The carrying on of such activities by a coordination center raises some questions.

Insurance companies carrying on their activities in Belgium are subject to the control of a public agency (Office de Contrôle des Assurances). One of the requirements in order to be approved as an insurance company is that the company should only be active in the field of insurance and reinsurance. A coordination center which carries on insurance activities should not carry on any other activity.

As to reinsurance, it is at this moment still not certain whether coordination centers may carry on reinsurance activities. A straightforward application of the "intra-muros" requirement would require that coordination centers practising reinsurance would only reinsure risks insured with affiliated companies. However, since the Law of 4 August 1986, insurance companies may not create or form coordination centers.[24] Hence, the contracting of reinsurance with other insurance companies would be excluded as insurance companies are prohibited from being affiliated with the group to which a center may render services.

Another interpretation would be to accept that the "intra-muros" requirement is met when the coordination center reinsures risks of group members insured by a nonaffiliated insurance company. It is still uncertain whether this second interpretation will be accepted.

C. Activities different from activities performed by group members

The authorities take the position that the activities engaged in by the center should be auxiliary to the activities of the members of the group.[25] With respect to certain activities, especially leasing, they prohibit the center from carrying out services for other group members involved in the same activities.

22. At the time this article was written, no Royal Decree of authorization has been issued.
According to officials of the Ministry of Finance, it seems that coordination centers would not need to receive a special Royal Decree for each issuance of bonds. A given Royal Decree would be valid for all public offerings within a certain period of time.
23. Administrative ruling of the Ministry of Finance of 25 November 1986.
24. Art. 7, Royal Decree No. 187, as introduced by Art. 42, Law of 4 August 1986.
This would be applicable to coordination centers approved after 30 August 1986, the date of entry into force of the above law.
25. Administrative ruling of the Ministry of Finance of 27 February 1987.

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D. Activities excluded for coordination centers

Coordination centers may not act as holding companies. They may not hold any shares of another company or enterprise[26].

All activities not explicitly listed as qualifying activities are also excluded. This is especially the case for commercial activities. The authorities could refuse the recognition as a coordination center to a center of which the activities resemble too closely purely commercial activities or for which the combination of certain authorized activities could be considered as too commercial[27].

III. CONDITIONS OF ELIGIBILITY

The conditions necessary for the coordination center to be recognized as qualifying under Royal Decree No. 187 can be grouped within two major categories.

A. Form conditions

A coordination center can take the form of a company incorporated in Belgium or can be established as a branch of a foreign company[28].

The choice will not have any adverse consequences with regard to the benefits attached to the recognition as a coordination center[29]. Most groups have given preference to a separate Belgian company.

It is no longer required to set up a new company or to open a new branch. An existing corporation or branch may be used, provided the activities they carry on thereafter are limited to qualifying activities.

No specific provision has been included as to the shareholders of the coordination center incorporated in Belgium. It should, however, be pointed out that a coordination center cannot be created by financial or insurance institutions[30, 31].

B. Substance conditions

1. International group

The coordination center must be part of an international group which presents certain characteristics (group requirements).

(a) *Notion of "group"*

For purposes of Royal Decree No. 187, a group is defined to include all companies affiliated with each other through direct or indirect ownership and placed thereby under a single control[32].

The control test will be deemed satisfied whenever one company holds directly or indirectly at least 20% of the capital of another company or 20% of the votes attached to the shares of the other company.

(b) *Size of the group*

The coordination center must be created by a group with a consolidated *capital* (net worth) of at least 1 billion Bfrs. Capital includes the following: stated capital, capital surplus, earned surplus, premiums, accumulated profits and losses.

The consolidated *turnover* of the group should be in excess of 10 billion Bfrs.

Intercompany capital shareholding and turnover should be excluded from the consolidated amounts[33].

It is not necessary that all members of the group which are taken into account for the calculation of the consolidated capital and turnover be users of the coordination center's services.

(c) *International character of the group*

Article 3, 1°, (a), of Royal Decree No. 187[34] specifies that a coordination center should be part of a group with international characteristics as provided by Royal Decree. Royal Decree of 3 November 1986 lists such characteristics[35]:

(i) The group should have at least one subsidiary in four different foreign countries. Such a condition should be met at the latest as of 1 January of the second year preceding the year during which the application for recognition as a coordination center was introduced.

Foreign branches of a company are not considered as fulfilling this requirement[36].

(ii) The consolidated capital of the group outside of Belgium should amount to 500 million Bfrs. or 20% of the consolidated capital of the entire group, whichever is less.

(iii) The group should realize, outside Belgium, a consolidated turnover of 5 billion Bfrs. of 20% of the total consolidated turnover of the group, whichever is less.

It can be expected that this last condition will be difficult to enforce, given the difficulty in determining the place where turnover has been realized.

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26. Art. 3, 5°, Royal Decree No. 187, as introduced by Art. 41, 2°, Law of 4 August 1986.
27. Cf. Conference of Minister Eyskens at Paribas, 6 March 1985, at 9.
28. Art. 1, Royal Decree No. 187.
A Belgian company should constitute a separate legal entity under Belgian company law. A joint venture is therefore excluded, since it does not have legal personality under Belgian company law.
29. A different taxation method has been in force for assessment years 1984 to 1987 for centers set up as Belgian branches of foreign companies before 8 January 1985.
30. See infra.
31. The provision of Royal Decree No. 187, which required that the center be recognized within a three-year period after the enactment of the Royal Decree, has been abolished by Art. 39, para. 1, 6°, Law of 27 December 1984.
32. Art. 2, Royal Decree No. 187.
33. Administrative ruling of Minister of Economic Affairs of 27 July 1985.
34. As introduced by Art. 41, 1°, Law of 4 August 1986.
35. Official State Gazette of 20 November 1986.
36. Under previous legislation it was sufficient for a group to have one subsidiary or one branch outside Belgium.

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(d) *Exclusions*

Banks, insurance companies, and other financial institutions are not permitted to establish a coordination center[37].

Preparatory works indicate that groups which include banks, insurance companies and other financial institutions, in addition to other companies, are not prohibited from forming a coordination center, provided such banks, insurance companies and other financial institutions are excluded from the group of companies for which a coordination center can provide its services[38]. This means that the group should in its application exclude all institutions of the above-mentioned type.

It should be pointed out that such an exclusion would not prevent coordination centers which have been recognized before 30 August 1986 from performing services on behalf of related institutions of this type.

2. Activities of the center

A coordination center may only carry on qualifying activities[39] for which it obtained an authorization and which are listed in the Royal Decree of recognition. It should carry them on only for the benefit of the group members.

A coordination center is not obliged to actually carry on all activities for which it has obtained an authorization.

3. Employment requirement

The coordination center must employ in Belgium the equivalent of at least 10 full-time employees before the end of the second year following the beginning of its activities (for new centers) or the beginning of the agreement period (for existing centers). No hiring before this date should be taken into consideration. This minimal level of employment should be maintained throughout the exemption period.

No conditions are imposed with regard to either the nationality of the employees or to their subjection to Belgian social security[40].

It seems, however, that the employees should be Belgian residents[41] even though they may be working outside of the country; foreign frontier workers should, however, be taken into consideration for employment requirement purposes[42].

Transferees from an existing Belgian company or branch to the center may be counted towards the 10 employee requirement on condition that such transferees are compensated by an additional hiring either in the transferring company or branch or in the coordination center to satisfy the requirement of a net increase of 10 additional full-time jobs.

The assignment of employees of a group member outside Belgium to the coordination center has, however, not been excluded.

IV. TAX CONCESSIONS

During a ten-year period the coordination center can take advantage of several tax concessions[43].

A. Corporate income tax and nonresident income tax

1. Forfeitary tax base[44]

Coordination centers are not taxed on the income they actually realize but on a forfeitary tax base. This base is determined as a percentage of certain operating costs borne by the coordination center. However, all personnel costs and financing charges are explicitly excluded from the calculation of the forfeitary tax base.

The percentage to be applied to the costs to determine the forfeitary tax base is not fixed by law. It will to a very large extent depend on the mark-up applied by the center itself in charging its services to the group members. This makes it possible for the center to determine itself, to some extent at least, its taxable income.

Tax will be levied at the normal corporate income tax rate of 43% for centers incorporated in Belgium and at the nonresident corporate income tax rate of 48% for coordination centers set up as Belgian branches of a nonresident company[45, 46].

Example 1:

A coordination center adopts the policy to charge out the services it renders at cost-plus 5%. It has a total cost of 100,000,000 Bfrs. of which financial and personnel costs amount to 85%.

37. Art. 7, Royal Decree No. 187, as introduced by Art. 42, Law of 4 August 1986; applicable to all centers recognized after 30 August 1986.
38. Preparatory works of the Law of 4 August 1986; Parliamentary Documents, Senate (1985-1986); No. 310/1, at 17.
39. See II above.
40. Administrative ruling of the Ministery of Employment and Labour of 8 September 1986; contra, Administrative ruling of the Minister of Social Affairs of 30 March 1987.
41. Administrative ruling of the Ministry of Employment and Labour of 2 April 1985.
42. Administrative ruling of the Ministry of Employment and Labour of March 1987 (undated).
43. The ten-year period starts on the first day of the tax year during which a request for recognition has been filed and expires on the last day of the tax year ending during the tenth calendar year following the year during which the request was filed.
44. This system of taxation is applicable to all coordination centers from assessment year 1988 onwards. In the original version of Royal Decree No. 187, coordination centers set up as Belgian companies were fully tax-exempt. Coordination centers set up as Belgian branches of foreign companies were only tax-exempt with respect to retained earnings in Belgium; nonresident income tax was assessed on 50% of the profits transferred out of Belgium. The original system of exemption has been abolished for the centers recognized as of 8 January 1985, by Art. 39, para. 1, 6°, Law of 27 December 1984. It has been abolished for the centers recognized before that date by Art. 51, para. 1, 2°, Law of 4 August 1986.
45. Arts. 24 and 33, Law of 4 August 1986 applicable as of assessment year 1988.
46. Reduced company tax rates are not applicable to Royal Decree No. 187 coordination centers. The 48% nonresident corporate income tax rate is subject to reduction under double taxation treaties.

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The forfeitary tax base is calculated as follows:

	Costs	*Percentage*	*Tax base*
Financial and personnel costs	85,000,000	0	0
Other costs	15,000,000	5%	750,000

Company tax: 750,000 × 43% = 322,500 Bfrs.

2. Minimum tax base

The taxable income of the center as defined above can in no event be lower than the sum of nondeductible expenses, directors' fees and "abnormal and gratuitous advantages" granted to the center.

The first two items – nondeductible expenses and directors' fees – should not be the object of concern for large multinationals since they can rather easily be avoided to a very large extent if the rules provided for by the law are properly complied with.

The "abnormal and gratuitous advantages" on the contrary should be a matter of concern. As mentioned, one of the basic ideas of the coordination center legislation was to allow multinational companies to reduce costs by centralizing their management and financial activities in an almost tax-free environment. However, there was a risk of abuse that profits would be transferred or shifted from the group members to the center.

It is in order to prevent such artificial transfers of profits that the rule of "abnormal and gratuitous advantages" has been adopted. Such advantages to the extent they exceed the forfeitary tax base will be taxable at the normal tax rate.

The "abnormal and gratuitous advantages" include the profits which result from transactions which do not meet the arm's length test. This might be the case when the center charges at a cost-plus rate which is deemed to be excessive.

It should be pointed out that the tax administration refuses to issue an advance ruling as to the arm's length character of a percentage[47]. The local tax inspector will decide on the percentage when he reviews and audits the annual income tax return of the coordination center.

Example 2:

The coordination center cited in the preceding example uses a cost-plus 20% formula (instead of cost-plus 5%), while the tax administration is of the opinion that the maximum arm's length percentage for this kind of services is 8%.

The "abnormal and gratuitous advantage" granted to the center is 20%–8% = 12%.

Abnormal and gratuitous advantage:

100,000,000 × 12% = 12,000,000 Bfrs.

Since this "abnormal and gratuitous advantage" of 12,000,000 Bfrs. exceeds the amount of the forfeitary tax base of 750,000 Bfrs., it is the former one which will be used.

Company tax: 12,000,000 × 43% = 5,160,000 Bfrs.

B. Withholding tax on interest, dividends and royalties

1. Exemption from withholding tax for interest, dividends and royalties paid or distributed by the coordination center

Interest and dividends paid or distributed either to resident or to nonresident taxpayers are exempt from Belgian withholding tax. The exemption is also granted to royalties paid for the use of intangible personal property.

2. Fictitious withholding tax applicable to interest and dividends paid or distributed by the coordination center

Recipients of dividends and interest paid or distributed by a coordination center receive the benefit of a fictitious withholding tax or deemed withholding tax equal to 25/75ths of the dividend or interest received which is treated as taxable income as well as tax credit. The excess of the fictitious withholding tax over the recipient's tax liability is refundable[48].

The mechanism of the fictitious withholding tax is illustrated in Examples 3, 4 and 5.

Example 3:

interest received from coordination center	100
fictitious withholding tax	33.3
taxable income	133.3
company tax (at 43%) before application of credit	57.3
credit for fictitious withholding tax	33.3
tax payable	24

Example 4:

The facts are the same as in Example 3, except that the lendor (bank) lending to the coordination center has itself borrowed funds and paid financial charges.

interest received from coordination center	100
fictitious withholding tax	33.3
taxable interest	133.3
financial charges	(90)
taxable income	43.3
company tax (at 43%) before application of credit	18.6
credit for fictitious withholding tax	(33.3)
tax refund	(14.7)

Examples 3 and 4 illustrate the substantial tax saving granted by the mechanism of the fictitious withholding tax. In Example 3 the effective rate of 24% compares very favourably with a rate of 43% which would normally be imposed on interest income.

Example 4 illustrates how the mechanism of the fictitious withholding tax can reduce the tax burden of the bank to zero and result in a tax refund.

47. It seems, however, that a percentage of 8% would be considered as normal.
48. Art. 29, 2°, (b), Law of 11 April 1983, as amended.

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Most banks and financial institutions are willing to share the tax saving with the coordination center through a reduction in the effective rate of interest on the loan. As a consequence of this reduction, the fictitious withholding tax has the same result as an interest subsidy. It has for a large part contributed to the success of the coordination center legislation.

Example 5:

The Belgian corporate shareholder who receives dividends distributed by a coordination center will normally benefit from the 95% intercorporate dividend deduction; only 5% of the dividend is actually taxable. The effect of the credit for the fictitious withholding tax, when combined with the intercompany dividend exclusion, results in a very substantial tax saving.

dividends distributed by the coordination center	1,000
fictitious withholding tax	333.3
taxable income before exclusion for intercompany dividends	1,333.3
intercompany dividend exclusion	(1,266)
taxable dividend	67.3
company tax at 43%	28.9
credit for fictitious withholding tax	(333.3)
excess credit – tax refund	(304.4)

The granting of the fictitious withholding tax which affords the recipients substantial tax reductions is subject to the following conditions[49]. Funds borrowed by the center which give rise to the interest payment should be used either by the coordination center or by a group member in:

(1) investments in new fixed tangible assets used in Belgium and not leased or rented to nongroup members or to group members established outside Belgium; or
(2) financing of research and development expenditures in the fields of energy preservation and the creation of new products and advanced technology, provided the expenditures are incurred in Belgium and depreciated over three years.

As to the fictitious withholding tax with respect to dividends, it is limited to dividends not exceeding 7.5% of the statutory capital[50] which is invested under conditions similar to those mentioned above with regard to interest payment.

The amount of the capital deemed used for the qualifying investments is computed on the basis of the net book value of the investments, i.e. their historical value less depreciation, at the end of the taxable period.

It is evident that the same investment cannot be taken into consideration for both tax credits, i.e. interest as well as dividends[51].

3. Exemption from withholding tax on interest received by the center on cash deposits

Under Art. 97, para. 5, of the Royal Decree implementing the Income Tax Code[52] interest received by the center on cash deposits is exempted from withholding tax. This measure is deemed to encourage the placing of excess cash with Belgian banks instead of with foreign banks in countries which impose no withholding tax on such interest.

Since the coordination center will as a rule qualify as a "professional investor" within the meaning of Art. 87, 4°, of the Royal Decree implementing the Income Tax Code, most other Belgian-source interest payments made to it will be exempt from withholding tax.

C. Real property withholding tax

Real property used by the coordination center for its own activities is exempt from real property withholding tax[53].

Such an exemption is not granted to real property leased to group members.

D. Registration duties

Coordination centers are exempt from the 0.5% registration tax on contributions to the capital of Belgian corporations[54]. This exemption is important for coordination centers which often require a very large capital to carry out their role of group finance center. Several coordination centers have a capital exceeding US$ 100,000,000.

Provided the Royal Decree of approval has already been enacted at the time the coordination center is formed or increases its capital, the exemption will come into play immediately. Otherwise, the local tax collector may require the payment of the registration tax which is then reimbursed later on, upon production of the Royal Decree of approval.

V. OTHER CONCESSIONS

A. Work permits and professional cards

Foreign employees and researchers hired by the center are exempt from the requirement of obtaining a professional card or a work permit. At the same time the employer is dispensed from the obligation to be authorized to hire foreign employees or researchers[55].

49. Only resident taxpayers and nonresident taxpayers subject to "regularisation" on their income in Belgium (i.e. foreign companies with a Belgian permanent establishment) can de facto take advantage of the tax credit.
50. The 7.5% rate may be modified by the Government on the basis of the fluctuations of the interest rates on the capital market.
51. Fictitious withholding tax with respect to royalties has been repealed by Art. 43, Law of 4 August 1986, applicable to royalties paid after 1 January 1986.
52. Royal Decree of 20 December 1984, Official State Gazette of 29 December 1987.
53. Art. 29, 1°, Law of 11 April 1983.
54. Art. 29, 3°, Law of 11 April 1983.
55. Art. 6, Royal Decree No. 187.

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B. Exchange controls

By separate application to the Belgian-Luxembourg Exchange Institute (Institut Belgo-Luxembourgeois du Change), it is possible for a coordination center to obtain nonresident status for Belgian exchange-control purposes, and therefore to make or receive payments to or from nonresidents free from Belgian exchange-control supervision, provided that at least roughly 80% of the center's financial transactions are carried on with the non-Belgian members of the group.

VI. RECOGNITION BY ROYAL DECREE – PROCEDURE

Coordination centers can only benefit from the tax concessions if they have been recognized by Royal Decree signed by the King and the competent Ministers[56].

No specific form requirement is imposed for the filing of an application request with the competent authorities.

The request should include all information necessary to allow the authorities to check whether all essential conditions are met (description of the group; consolidated capital and turnover; description of the purported activities; legal form of the center; method of remuneration of the center[57]).

The application should be signed by persons authorized to represent the coordination center. As a general rule, directors of a group company, often the Belgian affiliate, if any, sign the request.

The application should be forwarded to the Ministry of Finance. Usually, the request is simultaneously sent to the Ministry of Economic Affairs since it is in charge of the preparation of the file. The file is examined by a joint ministerial committee including representatives of all competent Ministers.

The Royal Decree of approval lists the activities for which the coordination center has received authorization. Some of the approvals explicitly exclude companies from the group for which the coordination center can perform its activities.

VII. TAX PLANNING CONSIDERATIONS

The question which is often raised is to what extent can a multinational group take advantage of the Belgian coordination center legislation or what are the tax planning considerations which should be taken into account.

It is not possible to answer this question in view of the large variety of possible factual situations. Two general comments may be made.

A. Fictitious withholding tax

The benefit of the fictitious withholding tax has the same effect as a subsidy. It is granted to the extent the borrowed funds or the contributed capital is used to finance the acquisition of tangible fixed assets to be used in Belgium or R & D activities carried on in Belgium. Therefore multinational groups which plan investments or R & D activities in Belgium should as a rule take the benefit of the fictitious withholding tax into consideration. Since the effect of the fictitious withholding tax is similar to an interest subsidy, foreign tax considerations will as a rule not play a role. The question whether the fictitious withholding tax may be combined with other Belgian Government assistance granted to investors should, however, be taken into account.

B. Taxation on notional income and exemption from withholding tax

Whether the taxation on notional income and the exemption from withholding tax are relevant or even determining tax planning factors will to a large extent depend on the tax legislation of the country of the parent company of the multinational group or of the company holding the shares in the coordination center.

In view of the large variety of factual situations and of national legislations, no general answer can be formulated. Only some general considerations can be expressed.

For Belgium-based multinational companies, permanent tax savings are possible especially by taking advantage of the taxation of the coordination center on notional income combined with the intercorporate dividend exemption.

For foreign-based multinational companies, the answer will to a large extent depend on whether that country applies the exemption or the foreign tax credit method as far as the taxation of foreign income is concerned. Permanent tax savings are almost certain, if the exemption method is applied. If, on the contrary, the foreign tax credit method is applied, the tax reductions granted by the Belgian coordination center legislation could be wiped out by the mechanism of the foreign tax credit. However, the coordination center might still be useful in such a situation: the tax reduction or exemption granted to a coordination center might lower the overall burden of the foreign taxes and therefore reduce or eliminate the excess foreign tax credit; the tax reduction or exemption may allow the accumulation of foreign income without paying Belgian and foreign taxes leaving a higher amount available for reinvestment, unless the U.S. subpart F or similar provisions apply. However, as mentioned, each particular case should be examined on its merits. In almost all cases some permanent tax saving can be achieved.

56. Minister of Finance, Minister of Economic Affairs, Minister of Employment and Labour, Minister of "Middle Classes".
57. Cf. Communication of Ministers of Finance and Economic Affairs, undated.

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When a coordination center is set up by a foreign-based multinational group, it must be decided whether the shares in the coordination center should be held by a Belgian company or by a foreign company. The decision will depend on whether or not the benefit of the fictitious withholding tax is granted to the dividends distributed by the coordination center. If such benefit is not granted, it is preferable to have the shares held directly by a foreign company, since the dividends distributed by a coordination center are exempt from Belgian withholding tax while dividends distributed by another Belgian company are subject to such withholding tax (normal rate 25%, but reduced by double taxation treaties to 15% and in some cases even to 10 or 5%). If the benefit of the fictitious withholding tax is granted, it could be preferable to have the shares held by a Belgian company, since the benefit of the fictitious withholding tax can exceed the burden of the withholding tax due by the Belgian company upon redistribution of the dividends it receives from the coordination center.

VIII. CONCLUSION AND FINAL COMMENTS

The list of coordination centers qualifying under Royal Decree No. 187 proves that the coordination center legislation has attracted a large number of major multinational companies. It may be considered as meeting the requirements of the multinational companies looking for a forum to set up centers to carry on administrative and other support activities and/or financial activities for the members of the group.

The administrative support functions are as a rule broadly interpreted to the satisfaction of the interested group. As to the financing activities, the experience of some multinational groups has demonstrated that the Royal Decree No. 187 coordination center provides an adequate legal and tax framework to introduce and realize coordinated treasury and exposure management via a centralized entity at a moment that the European financial markets are being liberalized. Such a center can grant full-time professional attention to said management which has become necessary as a consequence of the fact that financial instruments are becoming more sophisticated and that changes in financial techniques are occurring more rapidly.

The coordination center legislation has attracted many multinational companies, notwithstanding its many modifications since 1982. It should be emphasized, however, that all those modifications have not amended the basic features of the system: quasi-exemption from company tax for the profits realized by the coordination center and exemption from withholding tax for the interest and royalties paid and for the dividends distributed by the coordination center. It is expected that the coordination center legislation, which has become permanent, has reached a stage of stability and that it will not be subjected to major changes in the foreseeable future.

Exhibit 1:
List of coordination centers

Name of coordination center	Name of group
1. A.G. Philips Petroleum International	Philips Petroleum
2. Falconbridge International Limited	Falconbridge
3. N.V. Levi Strauss Financial Services	Levi Strauss
4. S.A. Dow Corning Coordination Center	Dow Corning
5. Cado Systems International Corporation	Continental Telecom
6. N.V. Blue Bell International	Blue Bell
7. S.A. Travex	Baxter Travenol Laboratories
8. S.A. Solvay Coordination Internationale des Crédits Commerciaux	Solvay
9. N.V. General Motors Coordination Center	General Motors
10. N.V. Safinco Coordination Center	Vandemoortele
11. N.V. I.B.M. Europe International Services Company	I.B.M.
12. N.V. Janssen International	Johnson & Johnson
13. N.V. Estée Lauder Coordination Center	Estée Lauder
14. N.V. Teepak Europe	Teepak
15. Beaulieu Management	Beaulieu
16. Soft Drinks Services Company	Coca-Cola
17. S.A. H.J. Heinz Central Europe	Heinz
18. S.A. American Express Overseas Credit Corporation	American Express
19. S.A. Tandy Europe	Tandy
20. Cigna International	Cigna
21. S.A. Cigna International Services	Cigna
22. S.A. C.H. Dexter Europe	Dexter
23. N.V. N L World Services	NL Industries
24. S.A. Auxiliaire de Coordination et de Gestion Internationale	La Redoute
25. S.A. European Owens Corning Fiberglas	Owens Corning
26. N.V. Raychem Finance Management Center	Raychem
27. C.D. Medical International Limited	Dow Chemical
28. S.A. Hampton Services	General Foods
29. S.A. Bemis Coordination Center	Bemis
30. S.A. Cordis International	Cordis
31. S.A. Computervision Coordination Center	Computervision
32. Mobil Polymers International Limited	Mobil
33. S.A. C & K Services	Crompton & Knowles
34. N.V. Avery Internationaal Coördinatiecentrum	Avery
35. S.A. 3 Suisses International Coordination Center	3 Suisses
36. N.V. GTE Coördinatie- en Financierings-centrum	GTE
37. N.V. K.N.P. Interservice	Koninklijke Nederlandse Papierfabrieken
38. S.A. Mölnlycke Europe	Mölnlycke
39. N.V. B.P. Capital	B.P.
40. N.V. Belgian Dairy Coordination Center	Comelco
41. S.A. Glaverbel Services	Glaverbel
42. S.A. Fin U.C.B.	U.C.B.
43. N.V. Federal Express European Services	Federal Express
44. N.V. Bekaert Coordination Center	Bekaert
45. N.V. Bunge Coördinatiecentrum	Bunge
46. N.V. Chicopee Coordination Center	Johnson & Johnson
47. N.V. Amycor	Amylum
48. Mac Dermott International Inc. Belgium Branch	Mac Dermott
49. S.A. GIB Coordination Center	G.B.-Inno-B.M.
50. Berkeley Administration Inc.	Claremont Pacific
51. S.A. Siemens Coordination Center	Siemens
52. N.V. Utexcor	Uco
53. N.V. Sabena Interservice Center	Sabena
54. S.A. Centre de Coordination "Générale" – Coördinatiecentrum "Generaal" N.V.	Société Générale de Belgique
55. S.A. Ladbroke International	Ladbroke P.L.C.
56. S.A. Petrofina International Group	Petrofina
57. S.A. Olin Europe	Olin Corporation
58. S.A. Société internationale de Services	Dollfus-Mieg & Cie
59. S.A. Damart System I.C.C.	Damart (Despature)
60. S.A. Bel Services	Bel
61. N.V. Haseldonckx Logistics	B.A.T.

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Name of coordination center	Name of group
62. S.A. B.S.N. Services	B.S.N.
63. S.A. Unifert Group	Fertitrust
64. S.A. Westinghouse Eelectric Europe-Coordination Center	Westinghouse
65. N.V. Nitto Finance and Management Center	Nitto
66. S.A. Raffinerie Tirlemontoise – Tiense Suikerraffinaderij Services (R.T.-T.S. Services)	Raffinerie Tirlemontoise
67. N.V. Amar Coördinatiecentrum	Amar (Sheraton)
68. N.V. Shell Coordination Center	Koninklijke Shell
69. S.A. Swedish Match International	Swedish Match
70. S.A. F.N. Coordination Center	F.N.
71. S.A. Diamant Board International Coordination Center	Sibeka
72. S.A. Renault Belgique International	Renault
73. Henkel Coordination Center	Henkel
74. S.A. Centre de Coordination "PRB"	P.R.B.
75. S.A. Vieille-Montagne-Services & Finance	Vieille Montagne
76. S.A. Gernel	Mestdagh
77. N.V. Eurocenter	Carnaud
78. S.A. Jasubeco	Jacobs Suchard
79. S.A. IBL Worldwide Coordination Center	IBL plc
80. C.P.C. Europe Limited	C.P.C.
81. S.A. Caterpillar Coordination Center	Caterpillar
82. S.A. PMC-Europe	Plastic Management
83. S.A. Philips Coordination Center	Philips
84. N.V. Dow Chemical Management International	Dow
85. N.V. General Instrument Europe	General Instrument
86. N.V. Sidal Coördinatiecentrum	Sidal
87. N.V. Transpetrol Services	Transpetrol
88. N.V. SGS Coordination Center	SGS
89. N.V. Volvo Truck Coordination Center	Volvo Truck
90. N.V. VC B.V. Coordination Center	Volvo Car B.V.
91. N.V. Al-Center	ALZ
92. N.V. Volvo Car Coordination Center	Volvo Car
93. N.V. Sidcenter	Sidmar
94. S.A. Colgate-Palmolive European Coordination Center	Colgate-Palmolive
95. S.A. Inchcape Coordination Center	Inchcape
96. S.A. Cockerill Sambre Finances et Services	Cockerill Sambre
97. N.V. Finco	Colruyt
98. N.V. Monsanto Services International	Monsanto
99. N.V. Himont Coordination Center	Himont
100. N.V. Cobrew	Artois
101. N.V. Infic	Bell Telephone
102. N.V. Sprague Electric Coordination Center	Penn Central Corporation
103. N.V. Alberto Culver European Coordination Centre	Alberto Culver
104. S.A. Beghin-Say-Service	Beghin-Say
105. S.A. Ferrero Coordination Center	Ferrero
106. S.A. Coordination Center Volkswagen	Volkswagen
107. S.A. Dixons Coordination Centre	Dixons
108. S.A. Ogilvy et Mather Worldwide Media	Ogilvy
109. N.V. Bowater Coordination Center	Bowater
110. N.V. Pumptech	Dowell Schlumberger Ala
111. N.V. Polysar Financial Services (Belgium)	Canada Development Corporation
112. N.V. Borsumij Europe	Koninklijke Borsumij Wehry
113. N.V. Coördinatiecentrum Aldi	Aldi
114. N.V. Cobelfret International	Cobelfret
115. N.V. Du Pont Coordination Center	Du Pont
116. N.V. Agfa-Gevaert International	Agfa-Gevaert
117. N.V. Essex Coordination Center	Schering Plough
118. N.V. Coördinatiecentrum N.I.M.	N.I.M.
119. N.V. Nedlloyd België	Nedlloyd
120. N.V. 3 M Coordination Center	3 M
121. N.V. Scott Paper Coordination Center	Scott
122. N.V. Verlacor	Versele-Laga
123. S.A. Société régionale d'investissement de Wallonie (S.R.I.W.)	S.R.I.W.
124. S.A. Centre de Coordination des Bétons	S.B.B.
125. S.A. U.G.B. International	Usines Gustave Boël
126. S.A. PB Corporate	Papeteries de Belgique
127. S.A. Alfina	Alfa-Laval
128. S.A. Systech	Papeteries de Belgique
129. S.A. Mo-Do	Mo-Do
130. S.A. Hachette	Hachette
131. S.A. Les Cables de Lyon	Cables de Lyon
132. S.A. Fabrique de Fer de Charleroi	Fabrique de Fer de Charleroi
133. S.A. Smith Kline et French Laboratories	Smith Kline
134. S.A. Les Etablissements Delhaize Frères et Cie Le Lion	Delhaize Frères et Cie Le Lion
135. S.A. Centre de coordination Nestlé	Nestlé
136. S.A. Burroughs Coordination Center	Burroughs
137. S.A. Accor	Accor
138. S.A. AT & T	American Telephone and Telegraph Co.
139. S.A. Acecor	A.C.E.C.
140. S.A. D'Ieteren Services	D'Ieteren
141. S.A. Econocom Centre de Coordination	Econocom

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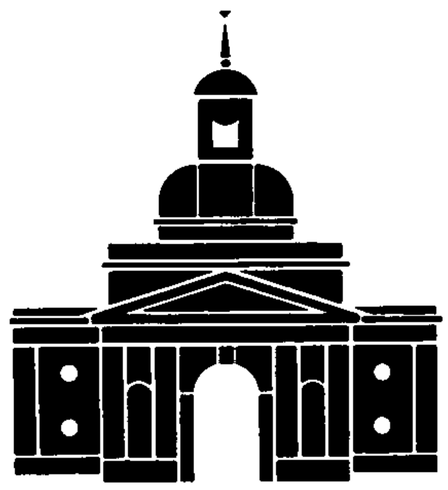

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BELGIUM:

Planning for Coordination Centers

After U.S. Tax Reform

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INTRODUCTION

With the stroke of his pen, President Reagan signed into law on 22 October 1986 the Tax Reform Act of 1986,[1] the most comprehensive tax legislation in the United States since 1954. This legislation was so extensive the Internal Revenue Code of 1954 was redesignated the Internal Revenue Code of 1986.[2]

The Act had a long gestation period. Almost two years passed between the time the first Treasury Report on Tax Simplification and Reform was released on 27 November 1984 and the date the Act was signed into law by President Reagan. This in itself was evidence of the major changes forthcoming. It is probably not fair to say that most of the Act's significant changes to the prior law were unexpected, since many U.S. and non-U.S. tax lawyers and accountants were following its two-year development. On the other hand, it is probably fair to say that most tax lawyers, individuals, and business managers were happy to see the legislative formation of the Act finally come to an end. If nothing else, the conclusion of this process permitted U.S. taxpayers and their advisors to once again carry out their tax planning activities in a relatively stable U.S. legislative environment.

One of the major groups of taxpayers which will see its tax planning significantly affected by the Act are U.S.-based multinational corporations. These taxpayers must be fully apprised of not only those provisions in the new IRC affecting the tax burden on U.S.-source income, but also those provisions affecting the tax burden on foreign-source income. Two major changes brought about by the Act which will influence the foreign tax planning of U.S.-based multinationals will be the reduction of the corporate tax rate and the modifications to the IRC foreign tax credit provisions.

U.S.-based multinational corporations earning income in a country other than the U.S. are generally taxed on that income in the other country. The U.S. also taxes the same income, but, to avoid double taxation, allows the multinational to claim a credit for the taxes it paid in the other country. Within certain limits, this credit (known as the foreign tax credit) can be used by the multinational as a dollar-for-dollar offset against its U.S. tax liability. To the extent the taxpayer pays more taxes on an item of income in a foreign country than its U.S. tax liability on the same income, the taxpayer will have excess foreign tax credits. If the taxpayer pays less foreign tax than its U.S. liability on an item of income, the taxpayer will be subject to a "residual" U.S. tax, that being the difference between the U.S. and foreign tax liabilities.

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1. P.L. 99-514, hereinafter "the Act".
2. Unless otherwise noted, all U.S. Internal Revenue Code Section references in this article are to the Internal Revenue Code of 1986, cited hereinafter as the IRC.

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Given that the Act reduced the maximum U.S. corporate tax rate from 46% to 34%,[3] and that the corporate tax rates of most other countries are higher, it is likely many U.S.-based multinationals will now be placed in an excess foreign tax credit position. This means that, all other things being equal, there will be a greater emphasis by U.S. multinationals on the reduction of their non-U.S. corporate income tax burden. To the extent a U.S. multinational can reduce its non-U.S. tax burden without giving rise to residual U.S. tax (i.e. if the reduction on non-U.S. tax only decreases excess foreign tax credits), the multinational will derive a 100% after-tax benefit from its effort.

Of course, there are limits to what multinationals can do to reduce their non-U.S. tax burden. For example, wholesale restructuring of foreign operations may not be possible for business reasons, or, if the restructuring were to trigger significant "up-front" costs such as goodwill transfer taxes or capital registration fees in the host country. From a U.S. tax standpoint, a multinational must be aware of what a change in its foreign operations will do to its U.S. tax liability. For example, the Act created new separate "baskets" of foreign-source income.[4] Income falling into each basket carries with it foreign tax credits for any foreign taxes paid by the multinational on that income. Reorganization of its corporate structure in such a way as to shift a multinational's income from the "overall" basket of IRC Sec. 904(d)(1)(I) to a different basket in IRC Sec. 904(d)(1) may produce no, or only minimal, savings for the company if it has no excess foreign tax credits in the separate basket.[5]

This article identifies and explains one opportunity for U.S.-based multinationals to reduce their non-U.S. tax burdens without falling afoul of U.S. tax problems such as the separate baskets of income. That opportunity is the Belgian Coordination Center (hereinafter cited as "CC"). While also discussing the Belgian tax aspects of CCs, this article's primary focus is on the U.S. tax repercussions of establishing a CC, particularly in light of the Act. A comprehensive analysis of the Belgian tax law, as it applies to CCs, is contained in the preceding article by Prof. J.P. Lagae, "Belgium: Coordination centers".

GENERAL DESCRIPTION OF A BELGIAN CC

CCs were introduced in Belgium in December 1982.[6] The stated purpose of the Belgian Government's action was to provide broad incentives for multinational companies to establish their regional headquarters in Belgium.[7] The incentives provided were, by and large, in the form of special tax concessions which permit CCs to operate in Belgium at an effective tax cost generally lower than that which would otherwise be paid under the "normal" Belgian corporate income tax law.

Since the initial release of Royal Decree 187, there have been several changes to the CC legislation.[8] Changes notwithstanding, the fundamental tenets of the original legislation continue to exist. In effect, these tenets permit companies to take advantage of the favorable CC tax legislation only under certain conditions. Broadly speaking, there are two primary conditions which must be satisfied. First, the entity in which a CC is housed must constitute a "qualifying entity" under the CC legislation. Second, the entity is permitted to engage in only certain "qualifying activities". Failure to satisfy either one of these conditions will result in a taxpayer not being allowed to take advantage of the Belgian tax concessions of CCs. Following is a brief discussion of what entities will qualify, what activities will qualify, and what tax concessions are available if all conditions are satisfied.

1. Qualifying entities

A coordination center may be established either as a Belgian incorporated company or as a branch of a company not a resident in Belgium.[9] However, a Belgian CC must belong to a "multinational group" of companies. To qualify as a multinational group, the following requirements must be satisfied:[10]

- the aggregate share capital (i.e. capital and reserves) of the consolidated group outside of Belgium must be worth at least 500 million Bfrs. or represent at least 20% of the total net assets of the group;

3. The 34% rate is effective for taxable years beginning on or after 1 July 1987. For taxable years including 1 July 1987, the effective tax rate is a blended (old and new) rate, determined under IRC Sec. 15. For calendar year taxpayers, the 1987 blended rate will be 40%.
4. IRC Sec. 904(d) provides for nine baskets of foreign-source income, including an "overall" basket. The pre-Act separate "categories" of income applicable to certain foreign oil and gas income have also been retained in IRC Sec. 907.
5. This concept is explained in detail later in this article.
6. Royal Decree 187, 30 December 1982, *Moniteur Belge/Belgisch Staatsblad* (hereinafter Official Gazette) of 13 January 1983.
7. Report to the King, Royal Decree 187, 30 December 1982.
8. See Law of 11 April 1983 Official Gazette, 16 April 1983; Royal Decree 20 December 1984 Official Gazette, 29 December 1984; Law of 27 December 1984 Official Gazette, 29 December 1984; Law of 4 August 1986 Official Gazette, 20 August 1986; Royal Decree 3 November 1986 Official Gazette, 20 November 1986. The two most important changes made to the original legislation are as follows. First, while initially CCs were fully exempted from Belgian corporate income tax, they now, as further explained in this article, must pay such tax based on a cost-plus formula. Second, certain limitations were introduced on the tax credit applicable to interest payments or dividend remittances by CCs, also further explained in this article.
9. It is interesting to note that a large majority of the multinationals which have already established CCs have opted for the form of a Belgian incorporated entity. The reasons may be that (a) no dividend withholding tax is imposed on profit remittances by a CC to its Belgian or foreign parent company and (b) in the case of dividends distributed by a CC to Belgian parent company, the parent company is entitled to a "fictitious withholding tax credit" when certain conditions are met. In comparison, these benefits are lost if the CC is established as a branch of a nonresident company. The withholding tax implications of CCs will be discussed in greater detail later in this article.
10. Royal Decree 187, 30 December 1982, Official Gazette, 13 January 1983; Royal Decree 3 November 1986, Official Gazette, 20 November 1986.

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- the group must demonstrate that it had one affiliated company located in at least four different countries on 1 January of the second year preceding the year in which the request for recognition as a CC is filed;
- the group must generate outside of Belgium either (a) a turnover (revenue) of at least five billion Bfrs. or (b) at least 20% of the group's total worldwide turnover; and
- the group must be comprised of two or more companies (current legislation sets a minimum of four), the capital or voting rights of which are owned 20% or more, directly or indirectly, by a parent company.[11]

Even assuming the multinational group requirements are satisfied, a CC will only qualify for the favorable Belgian tax status if it is demonstrated, by the end of the second year following start-up, that a minimum of 10 employees are working full-time for the CC.[12]

2. Qualifying activities

The types of activities that a CC may conduct under Royal Decree 187 fall into two broad categories: financial services and business support services, as outlined below. It is important to note that a CC may provide these permitted services only to companies within the CC's multinational group.

(a) Financial services

The following services are included in this category:

- reinvoicing of intercompany sales;
- leasing of fixed or movable assets to other members of the group;[13]
- factoring of intercompany trade receivables or third party receivables acquired from affiliated companies;
- hedging of foreign exchange risk; and
- financing in general, i.e. lending funds to other members of the group either by using the CC's own equity capital or through intercompany loans or outside borrowings.

(b) Business support services

The following services fall within this category:

- centralizing and coordinating of accounting, administrative and purchasing activities;
- collecting and disseminating information such as market surveys;
- advertising and other sales promotion activities;
- insuring and reinsuring risks of members of the group;
- interfacing with national or international government authorities;
- conducting research and development; and
- conducting other activities of a preparatory or auxiliary nature such as counseling in legal or tax matters, and supervising regional or corporate strategies.[14]

CCs are not allowed to conduct trading activities. (However, since a CC is authorized to perform preparatory and auxiliary activities, it may provide services auxiliary to the sales of other members of the group, such as market survey, inventory control and centralization of distribution activities.) CCs are also not allowed to own shares in other companies.[15] Finally, the activities performed by CCs must have an international character, i.e. the activities must benefit multinational group companies located within and without Belgium. For example, a CC which would predominantly engage in activities for the benefit of other Belgian affiliated companies would most likely not qualify for the favorable tax status even if such activities fall within the ones listed above.

3. Tax concessions

Before examining the various tax concessions granted to CCs, it is important to note that such concessions are limited to a ten-year period. However, the law of 27 December 1984 allows CCs to apply for a renewal of their tax status at the end of each ten-year period. This in effect means that CCs could enjoy the favorable tax status for a successive number of ten-year periods, provided, of course, they continue to satisfy the conditions of eligibility over each period.

The most important tax concession offered to a CC relates to the peculiarity of its tax regime. Rather than paying corporate income tax on the profits it generates, a qualifying CC pays a "notional" Belgian income tax, i.e. a 43% corporate income tax based on a certain percentage of the CC's total operating expenditures, *excluding* financing and personnel costs.[16] However, the taxable basis cannot be less than the sum of the CC's non-tax deductible items (e.g. corporate income taxes, social benefits costs, etc.), directors' fees and any abnormal or gratuitous benefits received by the CC from affiliated companies.

A second tax concession is granted in the form of a withholding tax exemption on payments by the CC of dividends and interest, regardless of whether the recipient of such income is a related or unrelated company or is a resident or nonresident of Belgium. Furthermore, Belgian resident companies or Belgian branches

11. While Royal Decree 187 would permit less than 50% owned subsidiaries to qualify as CCs, there may be significant U.S. disincentives for doing such. See the discussion in this article of major U.S. tax provisions, infra.
12. See Lagae, J.P., Belgium: Coordination Centers above.
13. We understand that the Belgian tax administration has stated that sale-lease back transactions can only be made if they pertain to new assets.
14. For further discussion on activities qualifying as preparatory or auxiliary, see Belgian Tax Administration Commentaries on Double Taxation Treaties, Article 5/321 through 5/328.
15. Law of 4 August 1986, Art. 41(5), Official Gazette, 20 August 1986.
16. The Belgian tax administration has not promulgated guidelines as to the level at which the percentage would be established. It is likely, however, that the percentage would be required to bear some relationship to the level of mark-up that the CC itself uses for charging its services to its affiliated companies.

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of foreign companies that receive dividend or interest payments from a CC are entitled to claim a Belgian tax credit (so-called fictitious withholding tax credit) equal to one third of the amount of dividends or interest actually received.[17] However, this credit is subject to certain limitations. The fictitious withholding tax (hereinafter "FWHT") applicable to interest is limited to interest paid on loans used to fund investments in new tangible assets located in Belgium or to finance research and development activities.[18] In the case of dividends, the applicable FWHT credit is restricted to an amount of dividends equal to a maximum 7.5% of that portion of the CC's paid up capital used to finance investment in Belgium in new tangible property or research and development activities.[19]

Other important concessions offered to CCs include the following:

- assets used by the CC in its business are exempt from Belgian real estate tax (précompte immobilier/onroerende voorheffing);[20]
- capital contributions made to CCs are not subject to the 0.5% Belgian capital issuance tax;
- foreign employees assigned to a CC are exempt from the obligation to obtain a work permit or a professional card; and
- a waiver of the Belgian-Luxembourg exchange control regulations may be obtained when the CC's transactions are predominantly (i.e. 75% or 80%) made with companies resident outside Belgium and Luxembourg.

MAJOR U.S. TAX PROVISIONS APPLICABLE TO ESTABLISHING A COORDINATION CENTER

In general, the major U.S. tax provisions which U.S. companies should be aware of when establishing a CC are as follows:

1. Subpart F provisions of IRC Secs. 951-964.
2. Separate baskets of income rules of IRC Sec. 904(d).
3. Passive foreign investment company provisions of IRC Secs. 1291-1297.
4. IRC Sec. 482 (Allocation of income and deductions among taxpayers).
5. Income tax creditability tests of IRC Sec. 901.

In addition to the above-mentioned provisions, which are all discussed in detail below, U.S. multinationals should also be aware of the foreign tax credit requirements of IRC Sec. 902 when establishing a CC. In general, under IRC Sec. 902 a U.S. parent company must own at least a 10% direct interest in a Belgian CC, or at least a 5% indirect interest (through another foreign subsidiary which owns at least 10% of the CC), to be able to credit foreign taxes paid by the CC. Furthermore, the Belgian CC should not be any lower than a third-tier foreign subsidiary since any foreign taxes paid by a fourth, or lower, tier foreign subsidiary are not creditable for U.S. tax purposes.[21] IRC Sec. 902 will not present any problems if the U.S. corporation establishes a first-tier Belgian CC subsidiary which is wholly-owned by the U.S. company, or a second or third-tier subsidiary which is wholly-owned by another wholly-owned subsidiary of the U.S. company. Less than wholly-owned subsidiaries may also be satisfactory, but the reader should be cognizant of the new separate income basket for dividends from each "noncontrolled Section 902 corporation".[22] A noncontrolled Section 902 corporation exists if the U.S. parent company owns, directly or indirectly, 50% or less of both the subsidiary's voting stock *and* the total value of the subsidiary's stock.[23]

1. Subpart F provisions of IRC Secs. 951-964

One of the tax advantages for a U.S. company establishing a subsidiary, instead of a branch, in a foreign country has been the ability to defer U.S. taxes on the foreign subsidiary's income. In general, income of a U.S. company's branch in a foreign country is subject to immediate U.S. taxation, while income of a foreign subsidiary is not taxed by the U.S. until distributed to the U.S. parent company. The exceptions to this general rule are contained in IRC Secs. 951-964, commonly known as the "Subpart F" provisions. Subpart F, enacted in 1962 during President Kennedy's admin-

17. Law of 4 August 1986, Art. 43, Official Gazette, 20 August 1986.
18. The tax incentive derived from the FWHT on interest can be illustrated by the following example. The first column shows a case where a CC pays $ 1,000 of interest to a Belgian resident company to finance new tangible assets. The second column shows the normal Belgian tax treatment of interest received by a Belgian company:

Interest received	$ 1,000	$ 1,000
Gross-up for FWHT	333	—
Taxable income	1,333	1,000
Corporate income tax at 43%	(573)	(430)
FWHT credit	333	—
Net tax payable	$ 240	$ 430

19. The FWHT credit applicable to a CC dividend is illustrated in the following example. The first column assumes that a CC with a share capital of $ 2,000 distributes a dividend of $ 100 to a Belgian corporate shareholder. One hundred percent of the CC's capital is used to finance new investments in tangible assets in Belgium. The second column shows the Belgian tax treatment of an ordinary dividend distribution by a Belgian company to its Belgian parent company.

	CC Dividend	Ordinary Dividend
Dividend amount	$ 100	$ 100
Withholding tax	—	(25)
Net amount received	100	75
Gross-up – Ordinary withholding tax	—	25
– FWHT	33.3	—
	133.3	100
95% dividend exclusion	(126.7)	(95)
Taxable	6.6	5
Corporate income tax 43%	(2.8)	(2.1)
Withholding tax credit	—	25
FWHT credit*	33.3	—
Net tax credit**	30.5	22.9
Net dividend + WHT/FWHT credit	$ 130.5	$ 97.9

* The full credit of $ 33.3 can be claimed since it does not exceed 33.3% of 7.5% of the CC's paid-up capital.
** This net tax credit can be offset against residual Belgian corporate income tax.

20. This exemption is not granted when the CC leases its assets to another affiliated company.
21. IRC Sec. 902(b).
22. IRC Sec. 904(d)(1)(E).
23. IRC Secs. 904(d)(2)(E), 904(d)(4)(A), and 957(a).

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istration,[24] is intended to subject certain kinds of potential "tax haven" income of controlled foreign corporations to immediate U.S. tax, whether or not distributed as a dividend to a U.S. parent. Under IRC Sec. 952(a), Subpart F income is defined to include the following kinds of income derived by a controlled foreign corporation:

(a) certain income from the insurance of property or risks outside the insurer's country of incorporation;
(b) foreign personal holding company income;
(c) foreign base company sales income;
(d) foreign base company services income;
(e) foreign base company shipping income; and
(f) foreign base company oil-related income.

While not listed as an item of Subpart F income per se, an increase of a controlled foreign corporation's earnings invested in U.S. property is also subject to immediate U.S. taxation.[25]

For the most part, depending on its activities, U.S. multinationals establishing a CC will be most concerned with items (a), (b), and (d) above. Item (c) should not be a concern primarily because it comprises income from sales activities which a CC is not permitted to engage in under Belgian Royal Decree 187. A similar rationale applies in the case of items (e) and (f), both of which primarily concern income which the CC is not likely to earn. (Note that CCs engaged in centralization of distribution services could potentially generate foreign base company shipping income.) The provisions regarding increased earnings invested in U.S. property could be a concern if the CC makes loans to a U.S. affiliate or owns property in the U.S.

Establishing a CC could convert what was previously non-Subpart F income of the multinational's group into immediately taxable Subpart F income. For example, assume a U.S. company owns a manufacturing affiliate in France. The affiliate wishes to invest $ 100 in a new plant in France to produce widgets. When sold, the widgets will contribute an additional $ 200 of before-tax income to the French affiliate over the life of the plant. This additional income to the French affiliate will not be Subpart F income, regardless of where the French affiliate sells the widgets. This is because the widgets are manufactured by the French affiliate in France, the country of the affiliate's incorporation. However, since the aggregate French corporate tax rate of 48%[26] is higher than the U.S. tax rate of 34%, any income received by the French affiliate from its widget operations, and remitted to the U.S. parent company, generates excess foreign tax credits.

Assuming the U.S. parent company is, and is expected to remain, in an excess foreign tax credit position, the additional French tax credits will be of no value. Consequently, the U.S. parent company wants to reduce the French tax on the French affiliate earnings. This can be accomplished by setting up a Belgian CC which will loan $ 100 to the French affiliate, enabling the French affiliate to purchase its new plant. The CC will charge arm's length interest on the loan, such interest being tax deductible in France by the French affiliate. This deduction reduces the French taxes (at the 48% rate). On the other hand, the interest earned by the CC is subjected to an aggregate foreign and U.S. tax of only 15%.[27]

The U.S. multinational must recognize, however, that it has just created Subpart F income. This is because the interest income received by the CC from the French affiliate is foreign personal holding company income under IRC Sec. 954(c). The "same country" exception of IRC Sec. 954(c)(3) does not apply because the interest income is received by the CC from an affiliate which (a) is not created or organized under Belgian law and (b) does not have a substantial part of its trade or business assets located in Belgium.

On the other hand, recognizing Subpart F income may not be of any concern to the U.S. multinational. This would be the case if the multinational assumes 100% annual dividend payout from its foreign affiliates (in effect making a conscious decision not to utilize the tax deferral tool of dividends) and, or, more importantly, if the multinational has excess foreign tax credits available to offset any residual U.S. tax on dividends or Subpart F income from its affiliates. In the case of excess credits, it is not important if the multinational receives income now, in the form of taxable Subpart F income, or later, in the form of dividends, if excess credits are available to shield either form of income from residual U.S. tax. What is important is that the multinational be able to use its excess credits against the residual U.S. tax imposed on the income earned by the Belgian CC. This would not be the case if the CC income is recharacterized under IRC Sec. 904(d) from overall basket income, where the multinational has excess credits, to another basket of income (e.g. the "passive" basket), where the multinational has no excess credits.

2. Separate baskets of income under Sec. 904(d)

The IRC Subpart F provisions were, to a large extent, unaffected by the Act. On the other hand, the separate baskets of IRC Sec. 904(d) represent a notable expansion, by the Act, of foreign tax credit limitations imposed on taxpayers. IRC Sec. 904(d) requires that

24. P.L. 87-834, 76 Stat. 960.
25. IRC Secs. 951(a)(1)(B) and 956.
26. This assumes (1) a 100% current dividend payout by the French affiliate to its U.S. parent and (2) that all the French affiliate's income is subject to tax only in France (and residually in the U.S.). The aggregate French corporate tax rate of 48% is comprised of a basic corporate tax rate of 45% plus a dividend withholding tax of 5% imposed on dividends remitted to a U.S. company.
27. This assumes the CC is directly owned by a U.S. parent company with excess foreign tax credits. In this case, the interest is subject to a 15% French withholding tax. (Belgium–France Tax Treaty, Article 16.) The CC is not subject to Belgian tax on the interest since its Belgian tax is based on total expenses. If the CC is owned directly by a U.S. parent, any dividends from the CC to the parent will not be subject to a Belgian dividend withholding tax. Assuming the U.S. parent has excess foreign tax credits which can be used to offset the residual U.S. tax on the CC dividends, no U.S. tax will be payable.

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U.S. taxpayers categorize their foreign-source income into nine separate baskets. The foreign tax credit limitation formula of IRC Sec. 904(a) must be applied separately to foreign taxes paid on each basket of income. The effect is that, in general, U.S. taxpayers will not be permitted to cross-credit foreign taxes paid on income in one basket against residual U.S. tax on income in a different basket. Consequently, a taxpayer may find itself in a position where it has excess foreign tax credits on overall basket income, but has a shortfall of credits on income in another basket, resulting in residual U.S. tax being payable on income in the latter basket.

The nine baskets of income established by IRC Sec. 904(d) are as follows:

(1) passive income;
(2) high withholding tax interest;
(3) financial services income;
(4) shipping income;
(5) dividends from each noncontrolled Section 902 corporation;
(6) certain dividends from a Domestic International Sales Corporation (DISC) or a former DISC;
(7) taxable income attributable to IRC Sec. 923(b) foreign trade income;
(8) certain distributions from a Foreign Sales Corporation (FSC); and
(9) all other (overall) income.

Although U.S. multinationals must be cognizant of all the income baskets, the ones which should be given the most attention when considering the establishment of a Belgian CC are baskets 1, 2, 3 and 9 above. "Passive" income is defined in IRC Sec. 904(d)(2)(A)(i) as any income "which is of a kind which would be foreign personal holding company income (as defined in Sec. 954(c))". Foreign personal holding company (hereinafter "FPHC") income includes dividends, interest, royalties, rents, annuities, gains from sale of property which produce the foregoing types of income (e.g. gains on the sale of a subsidiary's stock), gains on certain commodities and foreign currency transactions, and certain interest-equivalent income.[28] Certain dividends, interest, rents and royalties will not be FPHC, and therefore passive, income if received from a related person under certain circumstances.[29]

As a general rule, a U.S. company can assume that it will have passive income if it has FPHC Subpart F income. However, it is possible for a U.S. taxpayer to have passive income even without such income being treated as FPHC Subpart F income. For example, dividends received by a U.S. company from a controlled foreign corporation are, by definition, not FPHC Subpart F income, but may nonetheless be treated as passive FPHC income because of the "which is of a kind which would be" language of IRC Sec. 904(d)(2)(A)(i). Conversely, income which is FPHC Subpart F income may not constitute passive income because of the "look-thru" (as spelled in the Act) rules of IRC Sec. 904(d)(3) or because the income falls into another basket of income.

High withholding tax interest (Basket 2 above) is basically any interest received by a member of the multinational group, such interest having been subjected to a withholding tax (or other tax determined on a gross income basis) of at least 5%.[30]

Financial services income (Basket 3 above) basically includes income which is not passive income or high withholding tax interest and which is derived from the active conduct of a banking, financing or similar business, or derived from certain investments by insurance companies.[31] Financial services income also includes certain income which is of a kind which would be IRC Sec. 953(a) insurance income without regard to the "same country" exception of IRC Sec. 953(a)(1)(A).

Finally, as mentioned earlier, overall income (Basket 9 above) includes income which does not fall into any of the other baskets of IRC Sec. 904(d).[32]

There are two very important exceptions to the IRC Sec. 904(d) separate basket rules. These are the "high-tax kick-out" and "look-thru" rules.[33] The high-tax kick-out rule provides that income which would otherwise be passive basket income will not be so characterized if the direct and indirect foreign income taxes paid or accrued with respect to such income exceeds the result obtained by multiplying the highest U.S. tax rate against that income.[34] This rule is conceptually very similar to the Subpart F high foreign tax rule under IRC Sec. 954(b)(4). In general, if the aggregate *effective* foreign tax rate applicable to an item of a U.S. company's foreign-source passive income is higher than 34%, the high-tax kick-out rule will result in the income being characterized as overall basket income.

The purpose of the high-tax kick-out rule is to prevent the "manipulation of the character of income the effect of which is to avoid the purposes of the separate limitations [of IRC Sec. 904(d)]".[35] The U.S. Treasury Department has been authorized to issue regulations implementing the Congressional intent.[36] In general, the effect of the high-tax kick-out rule will be to force U.S. companies with passive basket income to have a shortfall of foreign tax credits in that basket.[37] This is because the passive basket includes only income which is not includable in another basket (IRC Sec.

28. IRC Sec. 954(c)(1).
29. IRC Sec. 954(c)(3).
30. IRC Sec. 904(d)(2)(B).
31. IRC Sec. 904(d)(2)(C).
32. IRC Sec. 904(d)(1)(I).
33. There are other exceptions, such as the Subpart F de minimis exception as applied under IRC Sec. 954(b)(3)(A). However, these other exceptions are not as important for purposes of this article as the two exceptions identified above. For example, the reduction of the Subpart F de minimis test to a lesser of 5% of gross income or $ 1 million may effectively eliminate the applicability of the de minimis exception for many multinationals.
34. IRC Sec. 904(d)(2)(F).
35. H.R. Rep. No. 841, 99th Cong., 2d Sess. II-567 (1986).
36. Id.
37. There may be some cases where this does not always occur; for example, should losses in another basket be used to offset income in the passive basket.

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904(d)(2)(A)(iii)(I)), and income which is subject to an effective foreign tax rate of less than 34%. As such, it will generally be the case that any passive basket income received or accrued by the U.S. company (whether in the form of dividends or deemed paid Subpart F income) will be subject to residual U.S. tax without full foreign tax credit offset. This makes it important, wherever possible, for a U.S. company to avoid structuring its operations in a form which will change otherwise overall basket income to passive basket income.

The second important exception to the IRC Sec. 904(d) basket rules is the provision for look-thru in the case of controlled foreign corporations.[38] As a very broad statement, income which is taxable to a U.S. company will be overall basket income if none of the U.S. company's subsidiaries have income falling within a separate basket. That is, the character (basket) of income taxable to the U.S. company will be determined by looking through the U.S. company to the payor affiliate, and determining the character of such income in the hands of the payor affiliate.

The look-thru rules will apply to any income received by a U.S. shareholder (as defined in IRC Sec. 904(d)(4)(B)) from a controlled foreign corporation (as defined in IRC Sec. 904(d)(4)(A)) in the form of Subpart F income, interest, rents, royalties, or dividends.[39] By virtue of IRC Sec. 904(d) defining U.S. shareholder and controlled foreign corporation via IRC Secs. 951 and 957, the stock attribution rules of IRC Sec. 318 are applicable.[40] In addition, except for a "minimal ownership interest" provision included in the Act's Congressional Committee Reports,[41] the "look-thru" rules will apparently be applied through as many affiliated corporations as are in a chain of income flow to a U.S. parent company.[42]

For example, assume a U.S. multinational parent company receives a dividend from a wholly-owned first-tier foreign corporation (hereinafter "First FC") which is attributable to interest income received by the First FC from a related company (hereinafter "Second FC"). The interest received by the First FC from the Second FC is in turn attributable to interest income received by the Second FC from another related foreign company (hereinafter "Third FC"). In this case, the character of the income in the U.S. parent's hands must be determined by looking all the way through to the character of income in the Third FC. If the Third FC has earned income which is passive income (e.g. interest income from an unrelated party), the interest paid by the Third FC to the Second FC will also be treated as passive income to the extent attributable to the Third FC's passive income. (In the case of interest payments between affiliates, all interest is first attributed to passive income of the payor, per the "interest netting" discussion in the House/Senate Conference Committee Report[43].) Conversely, if none of the related companies have any passive, high withholding tax, financial services, shipping, or noncontrolled IRC Sec. 902 dividend, income, the U.S. parent will also not have any such income.

Recall the example discussed earlier concerning the interest paid by a French manufacturing affiliate to a Belgian CC. It was concluded earlier that the interest payment from the French affiliate to the CC constituted immediately taxable Subpart F income to the U.S. parent company. It was also concluded this should not matter to the U.S. parent if it had excess foreign tax credits available to offset any residual U.S. tax on the income. (In this case the income was only subject to an aggregate foreign tax of 15% and would therefore be subject to residual U.S. tax.) Based on the explanation above, it must now be determined if the interest income will constitute overall basket income to the U.S. parent (in which case excess foreign tax credits are assumed available) or income in another basket (in which case excess credits are assumed not to be available). We will focus on the passive, high withholding tax and overall baskets.

Under IRC Sec. 904(d), it must first be ascertained whether the income is income in any basket other than the passive basket.[44] Since the interest payment from the French affiliate is subject to a 15% French withholding tax, the interest is initially classified as high withholding tax interest under IRC Sec. 904(d)(2)(B). However, if the French affiliate has earned no high withholding tax interest of its own, the interest paid to the CC will also not constitute high withholding tax interest under the look-thru rules of IRC Sec. 904(d)(3).

Even if the interest income to the Belgian CC is not high withholding tax interest, it may constitute passive basket income. It was concluded earlier that the interest income will be FPHC income to the CC. As such, the income also appears to be passive basket

38. IRC Sec. 904(d)(3).

39. IRC Sec. 904(d)(3). Any Subpart F income which is subject to the Subpart F 5% or $ 1 million de minimis rules of IRC Sec. 954(b)(3)(A) or the high foreign tax credit rule of IRC Sec. 954(b)(4) will not be subject to the look-thru rules and will automatically be classified as income in Baskets 6-9 identified earlier, normally Basket 9 (overall income). IRC Sec. 904(d)(3)(E).

40. IRC Sec. 904(d)(4) refers to IRC Secs. 951 and 957. IRC Secs. 951(b) and 957(a) both refer to IRC Sec. 958(b), which in turn cites IRC Sec. 318.

41. Under the "minimal ownership interest" provision, the look-thru rules will generally not be applied to payments from foreign entities in which a U.S. person owns a 50% or smaller interest. H.P. Rep. No. 841, 99th Cong., 2d Sess. II-573 (1986).

42. There is some question about just how far the look-thru rules will be applied. For example, technically, the look-thru provisions of IRC Sec. 904(d)(3) do not apply to items of income received by one foreign corporation from a second foreign company. However, the House/Senate Conference Committee Report on the Act states, by way of an example, that the look-thru rules will apply to payments between two related controlled foreign corporations "to the extent necessary to preserve the integrity of the separate limitations . . ." H.R. Rep. No. 841, 99th Cong., 2d Sess. II-581 (1986). See also Joint Committee on Taxation, 99th Cong., 2d Sess., General Explanation of the Tax Reform Act of 1986, at 901 (1987). The U.S. Treasury Secretary has been directed to issue regulations on the application of the look-thru rules. Id.

43. Id. at II-578.

44. IRC Sec. 904(d)(2)(A)(iii)(I). It is interesting to note that IRC Sec. 904(d)(2)(A)(iii)(I) requires the taxpayer to determine first if the income is overall income before passive income, while IRC Sec. 904(d)(1)(I) effectively requires the taxpayer to determine first if the income is passive income before overall income.

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income under IRC Sec. 904(d)(2)(A)(i). The high-tax kick-out exception of IRC Sec. 904(d)(2)(F) will not apply because the aggregate effective foreign tax rate on the CC's interest income is only 15%. However, again if the French affiliate has earned no passive income of its own, the look-thru rules of IRC Sec. 904(d)(3) will serve to treat the interest income received by the CC (and taxable to the U.S. parent company, whether in the form of a dividend or Subpart F income) as overall basket income. Under these circumstances, the net result is that the U.S. parent company will receive income which is only subject to an effective aggregate foreign and U.S. tax rate of 15% (after application of excess overall basket foreign tax credits).

3. Passive foreign investment company provisions of IRC Sec. 1291-1297

New IRC Secs. 1291-1297 added by the Act could cause some consternation among U.S. multinationals seeking to establish a CC. These provisions deal with the treatment of certain "passive foreign investment companies" (hereinafter "PFIC"). In general, to the extent a distribution from such a company exceeds 125% of the average annual amount distributed over the prior 3 years, a tax *plus interest* will be payable by the distributee. (There are certain exceptions outlined in IRC Secs. 1291-1297 which may be applicable.)

A PFIC is defined in IRC Sec. 1297 as a foreign corporation where either (a) 75% or more of such corporation's gross income is passive income, or (b) 50% or more of the value of such corporation's assets are held for the production of passive income. Passive income is defined as having the meaning assigned to such term by IRC Sec. 904(d)(2)(A), without regard to the exceptions in clause (iii) thereof.[45] In addition, a literal interpretation of IRC Sec. 1296(b) indicates that the "look-thru" rules of IRC Sec. 904(d)(3) will not apply, except in the case of "vertical" payments from certain subsidiaries of the PFIC. Thus, unless otherwise exempted from the PFIC rules, a foreign company (including a CC) could be required to report, and pay tax and interest on, PFIC income even through the company would not have any passive basket income under IRC Sec. 904(d).

Overriding all of the above, the PFIC provisions should generally not be of major concern to controlled foreign corporations that are subject to the Subpart F rules discussed earlier in this article.[46] Nonetheless, there are some uncertainties in this areas, and U.S. multinationals should follow future developments to determine if the PFIC rules could in any way apply upon the establishment of a CC.[47]

4. IRC Sec. 482

IRC Sec. 482 in general provides the U.S. Treasury Secretary with the authority to reallocate income, deductions, credits or allowances between members of a U.S. group of companies (either foreign or U.S. companies). Provisions similar to Sec. 482 exist in the tax laws of virtually all countries.

IRC Sec. 482 is highlighted here for two reasons. First, while a Belgian CC can prove to be a useful tool for U.S. multinationals, the extremely broad powers of the U.S. Treasury Secretary, and authorities in other countries, must be kept in mind when establishing the payments (in the form of rentals, service charges, insurance premiums, etc.) that affiliates will make to the CC. These payments must meet the tests of Treas. Reg. Sec. 1.482, and the comparable tests established by other countries. These tests are commonly referred to as "arm's-length" tests. Second, a new intangible property requirement, commonly referred to as the "Super Royalty Provision", was added to IRC Sec. 482 by the Act.

As mentioned in the "General description of Belgian CCs" section of this article, CCs are permitted to engage in research and development activities. If the CC does engage in such activities, and shares its findings with other affiliates (e.g. through a technology licensing agreement), it must be cognizant of the new Super Royalty Provision. The Super Royalty Provision requires taxpayers to receive income "commensurate with the income attributable to the intangible" which is transferred (e.g. licensed) to an affiliate.[48] While the Treasury Department has yet to issue regulations on this matter, it is possible taxpayers will be required to estimate the income an intangible will produce (over the entire life of the intangible), and make periodic adjustments if the initial income projections are inaccurate.[49]

5. Income tax creditability tests of Sec. 901

As mentioned earlier in the general description of CC's portion of this article, CCs and their corporate shareholders are subject to different tax rules in Belgium than most corporations. For example, the CC is subject to a Belgian notional tax which is based on a certain percentage of the CC's expenses, instead of the general Belgian corporate income tax, which is based on the net income of the corporation. In addition, subject to the conditions described earlier, Belgian corporate recipients of dividends and interest from a CC are entitled to claim a fictitious withholding tax

45. IRC Sec. 1296(b)(1).
46. IRC Sec. 951(f) and H.R. Rep. No. 99-841 99th Cong., 2d Sess. II-640 (1986).
47. 86 *Taxes International* at 5 (December 1986), where it is stated that the "PFIC provisions have the potential to affect everyone" and that "taxpayers will not be able to comply with the law until better guidance is provided". See also H.R. 2636, 100th Cong., 1st Sess., Sec. 112(n) (1987). H.R. 2636 (the Technical Corrections Bill of 1987) was unenacted at the time this article was required to be submitted for printing. However, if enacted as proposed in the House Ways and Means Committee, it would eliminate some technical deficiencies in the Act, but nonetheless leave open the possibility that CCs subject to the Subpart F rules could also be subject to the PFIC interest penalty provisions in certain circumstances.
48. IRC Sec. 482.
49. 5 March 1987 IRS/Treasury Department Public Hearing, as summarized in *Tax Notes*, 9 March 1987 at 945.

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credit against their normal Belgian corporate income tax. In the case of Belgian corporate shareholders, the fictitious withholding tax on dividends from a CC will often generate a reduction of the shareholder's corporate income taxes. (See example in footnote 19, supra.)

The favorable Belgian tax regime under which CCs operate gives rise to an issue of whether, or to what extent, a CC's Belgian income taxes are creditable for U.S. tax purposes under IRC Secs. 901 and 903. A comprehensive discussion of IRC Secs. 901 and 903 is well beyond the scope of this article, given the complexities of the issues involved.[50] However, the issues are important enough to merit some general discussion herein, with the caveat that any definitive conclusions should be reached by each U.S. taxpayer based on its own particular facts and circumstances.

For a U.S. parent company to claim a foreign tax credit for Belgian taxes paid by a CC, the parent must demonstrate that the tax is a creditable tax under either IRC Sec. 901 or 903. To qualify as a creditable tax for U.S. purposes, the notional Belgian tax paid by a CC must constitute a "tax" within the meaning of Treas. Reg. Sec. 1.901-2(a)(2), and its predominant character must be that of an "income tax" in the U.S. sense under Treas. Reg. Sec. 1.901-2(a)(3). Moreover, if a Belgian CC constitutes a "dual capacity taxpayer" under Treas. Reg. Sec. 1.901-2(a)(2)(ii), and the application of Belgium's corporate tax to the CC is different, either by the terms of the tax or in practice, from the normal Belgian corporate tax, the CC's U.S. parent must prove that both the general Belgian tax and the tax applied to the CC are creditable for U.S. purposes.[51]

A CC could be found to be a dual capacity taxpayer only if the CC or a party connected (via ownership or transactions) to the CC received a "specific economic benefit" from the Belgian Government under Treas. Reg. Sec. 1.901-2(a)(2)(ii)(B). The existence of a specific economic benefit in the case of a CC is difficult to establish,[52] meaning it is unlikely a CC will be found to be a dual capacity taxpayer. In such case, it must only be proven that the CC's Belgian taxes are either creditable IRC Sec. 901 taxes or creditable IRC Sec. 903 taxes in lieu of an income tax. As discussed in the next paragraph, while it is unlikely a CC's notional Belgian tax would qualify as an IRC Sec. 901 tax, it should qualify as an IRC Sec. 903 tax.

To address both sides of the issue, however, let us assume for the sake of argument that a CC is found to be a dual capacity taxpayer. In this case, it must be determined whether the Belgian tax the CC pays is different, either by its terms or in practice, from the general Belgian corporate income tax. Suffice it to say that the Belgian CC tax would most likely be considered a separate tax, under Treas. Reg. Sec. 1.901-2A(a)(1). If so, it must then be proven that both the general Belgian corporate income tax and the tax paid by the CC are creditable taxes under IRC Secs. 901 and 903. There should be no problem in proving the creditability of the general corporate tax. With respect to the latter tax, it is difficult to prove that the tax paid by the CC is creditable under IRC Sec. 901. This is primarily because the CC's Belgian tax is not imposed on the basis of the CC's gross income as reduced by the CC's significant costs and expenses (including recovery of capital expenditures). These are the so-called "gross receipts" and "net income" tests of Treas. Reg. Sec. 1.901-2(b)(3) and (4).

Alternatively, as long as the notional tax paid by the CC is compulsorily required by Belgian law (thus qualifying as a "tax" under Treas. Reg. Sec. 1.901-2(a)(2)), it can be argued that the notional tax is a "tax in lieu of an income tax" under IRC Sec. 903. This argument should prevail since, under Treas. Reg. Sec. 1.903-1, the basis of the "in lieu of tax" is irrelevant as long as it can be demonstrated that the CC is not subject to the general Belgian income tax. This is clearly the case with Belgian CCs.

Even after proving that the CC's Belgian tax is an "in lieu of tax" under IRC Sec. 903, the process is not yet totally completed if the CC is indeed found to be a dual capacity taxpayer, as discussed above. It must now be demonstrated what portion of the CC's Belgian income tax is not related to the CC's (or another party's) receipt of a specific economic benefit from the Belgian Government. This burden of proof must be satisfied under either the "facts and circumstances method" or the "safe harbor formula" found in Treas. Reg. Sec. 1.901-2A(c)(2) and (3).

Application of the facts and circumstances method, as the name implies, will require that the CC's U.S. parent use all relevant facts and circumstances to establish the amount of the CC's Belgian tax which is not paid in exchange for a specific economic benefit. The safe harbor formula on the other hand, allows the taxpayer to prove, via the formula provided in Treas. Reg. Sec. 1.901-2A(e), that the CC paid no more Belgian corporate income tax than it would have had it been subject to the general Belgian corporate income tax. In general, it is expected that application of the safe harbor formula should result in the entire amount of Belgian corporate income taxes paid by a

50. The IRC Secs. 901 and 903 Treasury Regulations, as printed in the Commerce Clearing House Compilation of Income Tax Regulations, are themselves 46 pages in length.

51. The IRS has not ruled on the creditability of the Belgian income tax paid by CCs, or on the creditability of the general Belgian corporate income tax. It is of some interest that the IRS made a presumption in Private Letter Ruling 8524009 that the general Belgian corporate tax was a creditable income tax under IRC Sec. 901. However, the presumption was made only in arguendo for the purposes of addressing the creditability of a different Belgian tax (a prepayment of real estate tax). Furthermore, private letter rulings cannot be cited as precedent. IRC Sec. 6110(j)(3).

52. There are a number of reasons for this difficulty. For example, a CC or connected party does not receive, from the Belgian Government "property; a service; a fee or other payment; a right to use, acquire or extract resources, patents or other property that . . . the Belgian Government owns or controls; . . . or a reduction or discharge of a contractual obligation" as required under Treas. Reg. Sec. 1.901-2(a)(2)(ii)(B). Actually, a CC is merely a particular form of entity through which a company has the right or privilege to conduct its business. This does not constitute a specific economic benefit. Treas. Reg. Sec. 1.901-2(a)(ii)(B).

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CC being creditable for U.S. purposes. However, this may not always be the case, particularly if the Belgian CC's expenses equal or exceed its revenues. Theoretically, this should not occur if the Belgian CC's profit element charged on services rendered to other affiliates is fairly consistent with the profit percentage applied by the CC to its expenses in determining the CC's notional Belgian income tax. Nonetheless, this is an issue which U.S. multinationals should consider when establishing a Belgian CC.

EXAMPLE

To summarize the legal and technical principles discussed above, this section presents one example of how a Belgian CC might be established and operated. Structured and operated in the manner set forth in this example, a CC would be entitled to the Belgian tax concessions described earlier in this article while still avoiding potential U.S. tax pitfalls, such as the separate baskets of income.

This example assumes a CC is incorporated in Belgium.[53] The CC is a wholly-owned subsidiary of Belco, a Belgian-incorporated company with ordinary business operations in Belgium. Belco is in turn wholly-owned by a U.S. parent company (USCo). Unless otherwise specified, it is assumed the CC obtains its funds necessary to carry on its activities via capital contributions from Belco.

It is assumed the CC engages in its activities primarily with its Belgian parent company or any other corporate member of the group which is incorporated and resident in Belgium. This assumption is made to demonstrate the optimal Belgian tax benefit (i.e. FWHT on interest or dividends) resulting from the use of a CC. However, as mentioned in the general description of CCs portion of this article, it must be remembered that certain activities, in particular those where a CC is carrying out activities predominantly with its Belgian parent company or another Belgian resident company, will not suffice *by themselves* to make such a CC qualify for favorable Belgian tax status.

Three final assumptions are made for the sake of simplicity. First, all affiliates of the CC are assumed to be 100% direct or indirect subsidiaries of USCo, with none of the affiliates being lower than a third-tier foreign subsidiary. Second, it is assumed all of the affiliates earn only overall basket income (under IRC Sec. 904(d)(1)(I)). Third, no foreign exchange gains are assumed to arise on the repayment of loans between an affiliate and the CC. (Taxpayers considering the establishment of a CC should, however, be cognizant of the potential generation of passive basket (foreign exchange) income in certain loan repayment circumstances under IRC Secs. 988 and 954.)

CC financing activities

There are a multitude of financing activities in which a CC could engage. This example focuses on two approaches, with two "prongs" to each approach. A Belgian and U.S. analysis of each prong is performed, resulting in eight separate segments to this example. In outline form, the example will be presented as follows:

A. Approach A – CC *uses its equity capital* (as contributed by Belco) *to finance activities of other affiliates*
   1. Prong 1 – CC lends money to Belco or another Belgian affiliate
      a. Belgian analysis
      b. U.S. analysis
   2. Prong 2 – CC lends money to a non-Belgian, non-U.S. affiliate
      a. Belgian analysis
      b. U.S. analysis

B. Approach B – CC *uses debt financing* from other affiliates *to finance the CC's activities* (e.g. centralized group accounting services or research and development)
   1. Prong 1 – CC obtains financing from Belco or another Belgian affiliate
      a. Belgian analysis
      b. U.S. analysis
   2. Prong 2 – CC obtains financing from a non-Belgian, non-U.S. affiliate
      a. Belgian analysis
      b. U.S. analysis

Approach A, Prong 1 – Belgian analysis

Interest paid by Belco to the CC must satisfy an arm's-length test under Belgian law. The Belgian Income Tax Code (hereinafter "ITC") provides for a safe harbor rate whereby interest not exceeding the interest rate of the Belgian National Bank increased by three percentage points is considered to be arm's-length.[54] The portion of any interest paid to the CC that did not meet the arm's-length requirement would not be deductible by the Belgian payor.

Assuming the interest paid to the CC is on an arm's-length basis, the income to the CC would not increase the CC's taxable basis since the Belgian notional tax is assessed on the basis of the CC's overall expenditures, excluding personnel and financing costs. Finally, when the CC distributes its interest income to Belco in the form of a dividend, Belco will be entitled to a FWHT credit equal to 33.3% of the dividend (subject to the limitations set forth earlier in this article).

Approach A, Prong 1 – U.S. analysis

Regardless of whether a CC is loaning money to

53. The formation of the CC would be accomplished free of U.S. formation tax under IRC Sec. 351, whereby the CC's sole owner would contribute capital to the CC in exchange for all the CC's stock. Similarly, under Belgian law, a CC can be established free of Belgian income or capital issuance tax. Art. 29, Law of 11 April 1983. Official Gazette, 16 April 1983.
54. Art. 50(1) ITC.

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another Belgian affiliate or a non-Belgian affiliate, the loan must be on arm's-length terms under IRC Sec. 482. The arm's-length rate must be equal to the rate which would be charged "in independent transactions with or between unrelated parties under similar circumstances".[55]

Interest paid to the CC by a Belgian affiliate will be deductible by the affiliate for U.S. earnings and profits purposes. The interest income to the CC would not constitute Subpart F income since the income is not FPHC income (the only Subpart F category into which the income could fall) by virtue of the same country exception of IRC Sec. 954(c)(3)(A)(i).[56]

The CC's interest income should constitute overall basket income under IRC Sec. 904(d)(1)(I). This means that when remitted to USCo in the form of a dividend, the CC's interest income can be shielded from residual U.S. tax by excess overall basket foreign tax credits of USCo. The interest income to the CC will not constitute high withholding tax interest under IRC Sec. 904(d)(2)(B), because (a) no Belgian withholding tax is imposed on dividend payments from the Belgian debtor affiliate to the CC, and (b) in any case, the look-thru rules of IRC Sec. 904(d)(3) would treat the income as non-high withholding tax income if the Belgian affiliate had earned no such income of its own.

The interest will not constitute passive basket income under IRC Sec. 904(d)(2)(A) because the interest is not FPHC income, as discussed above. In addition, the look-thru rules would except the income from passive basket treatment if the Belgian debtor affiliate has no such income of its own.

The CC's interest income should not constitute financial services income because the CC is not engaged in the kinds of activities (banking, etc.) encompassed in IRC Sec. 904(d)(2)(C). Again, even if the CC's loan to the Belgian affiliate were considered a "financial services" activity, the look-thru rules of IRC Sec. 904(d)(3) would treat the interest as non-financial services income to the extent the Belgian debtor affiliate was not engaged in such activities. The CC's interest income will not fall into any of the other separate income baskets of IRC Sec. 904(d), meaning that by default, it is treated as overall basket income.

Once the CC receives its interest income, it remits such income, in the form of dividends, to Belco, its Belgian parent company. These dividends will not constitute Subpart F income to Belco, assuming a substantial part of the CC's assets are used in Belgium, thereby giving rise to the same country exception of IRC Sec. 954(c)(3). In addition, Belco's dividend income from the CC should constitute overall basket income. For reasons similar to those expressed above, the dividend income will not be categorized as financial services income. As a dividend, the income cannot, by itself, constitute high withholding tax interest unless the "look-thru" rules treat it as such. Based on our analysis above, this will not happen. Finally, the dividend will not be passive basket income because (a) it is not FPHC income to Belco, and (b) the look-thru rules of IRC Sec. 904(d)(3) will except the income from the passive basket, as explained above.

Finally, when Belco dividends its income to USCo, the income cannot, by definition, be treated as FPHC, Subpart F income to USCo because USCo itself is not a controlled foreign corporation. In addition, under the same rationale used above, the dividend income to USCo should constitute overall basket income under IRC Sec. 904(d)(1)(I). However, note that absent the "look-thru" rules, the dividend income to USCo could be treated as passive basket income. Under a literal interpretation of IRC Secs. 904(d)(2)(A)(i) and 954(c), the dividend received by USCo is income "which is *of a kind* which *would be* foreign personal holding company income . . . ." (Emphasis added.) This is a somewhat unusual result because the dividend income to USCo cannot actually be FPHC income since USCo is not a controlled foreign corporation. In this case USCo cannot utilize the same country exception rule of IRC Sec. 954(c)(3)(A)(i) to exclude its dividend from being treated as income which "would be" foreign personal holding company income because, literally interpreted, the language of IRC Sec. 954(c)(3)(A)(i) applies only to dividend recipients that are controlled foreign corporations.

Approach A, Prong 2 – Belgian analysis

Generally, tax would be withheld at the source upon interest payments made to a Belgian CC by a foreign affiliated company. In most treaties concluded by Belgium with European countries the withholding tax rate is either 10% or 15%.[57] The Belgian CC would not be entitled to claim a credit for the foreign tax withheld against its own Belgian tax liability.

Assuming the arm's-length interest requirements are met, the paying company would be able to claim a deduction for the interest paid for purposes of determining its own taxable income. No Belgian FWHT credit would be available on subsequent dividend distribution by the CC of its interest income since the condition for eligibility, that is, the use of the loaned funds for acquisition of new tangible business assets in Belgium, would not be satisfied.

Approach A, Prong 2 – U.S. analysis

From a U.S. standpoint, the treatment of interest received by the CC from non-Belgian, non-U.S. affiliates will be slightly different from the treatment accorded to interest on loans to Belgian affiliates (Approach A, Prong 1 above). The one main difference

55. Treas. Reg. Sec. 1.482-2(a)(2).
56. This example assumes the Belgian debtor affiliate has assets, and operates, only in Belgium, thus satisfying Part II of the same country exception of IRC Sec. 954(c)(3)(A)(i).
57. Note that the Belgium/Netherlands treaty provides that no tax is withheld in the case of interest paid to a Belgian company which does not own directly at least 25% of the shares of the Dutch paying company. Treaties with Luxembourg and Germany also provide for a zero withholding tax rate on interest paid to a Belgian company which does not own directly or indirectly at least 25% of the shares of the paying company.

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should be that the interest income will constitute FPHC income to the CC, immediately taxable to USCo. This should not be of any concern to USCo as long as the income is categorized as overall basket income and USCo has excess foreign tax credits in that basket.

Unlike interest on loans to Belgian affiliates, interest received by the CC on loans to non-Belgian affiliates will be FPHC income because the same country exception of IRC Sec. 954(c)(3) will not apply. (The CC receives interest from a related person which is not incorporated under the same country laws as the CC, and the debtor affiliate does not have a substantial part of its assets used in a trade or business in Belgium.)

Despite being Subpart F income, the interest received by the CC should nonetheless constitute overall basket income. The interest is not financial services income for the same reasons discussed earlier in Approach A, Prong 1. The interest could constitute high withholding tax interest if (as is likely) the debtor affiliate's home country imposes a withholding tax of at least 5% on payment of the interest to the CC. Alternatively, the interest could be treated as passive income because it is FPHC income to the CC, thus satisfying IRC Sec. 904(d)(2)(A)(i). Nonetheless, since the look-thru rules of IRC Sec. 904(d)(3) apply to income otherwise treated as passive or high withholding tax income, the CC's interest income will not be categorized as either type of income, assuming the debtor affiliate itself earns no such income.

Once it is concluded that interest in the CC's hands is overall basket income, the same rationale explained in Approach A, Prong 1 will result in dividends ultimately flowing to USCo as also being overall basket income.

Approach B, Prong 1 – Belgian analysis

The interest paid by the CC to its affiliate lender would have no effect on the CC's overall Belgian tax liability since the notional tax is based on the CC's expenses, excluding personnel and financing charges. The interest income to the lending affiliate would be fully subject to Belgian corporate income tax. However, a FWHT credit would be granted to the recipient if the funds borrowed by the CC were used to acquire new tangible assets in Belgium or perform research and development activities. If the funds loaned to the CC were used for any other purpose, the lending affiliate would receive no FWHT credit in Belgium. (For example, the CC's use of funds borrowed from Belco to pay salaries of CC employees providing accounting services to other affiliates would not give rise to a FWHT benefit.)

Directionally, if a CC is to make investments in new Belgian property or perform research and development activities, it would probably be more tax efficient to do so via capital contributions from a Belgian parent company than via interaffiliate loans. This is because, while the FWHT credit would arise in either case, interest received by the Belgian lender would be fully taxable while dividends received by the Belgian parent would be 95% exempted from tax. (One must bear in mind, however, that the FWHT credit is limited to dividends equal to a maximum 7.5% of the CC's paid-up equity.)

Approach B, Prong 1 – U.S. analysis

The loan by Belco (or another Belgian affiliate) to the CC must, as discussed under Approach A, meet the arm's-length requirements of IRC Sec. 482. In addition, where Belco makes a loan to the CC, the taxpayer must be cognizant of the so-called debt-equity rules of IRC Sec. 385. To the extent the CC is considered to be "thinly capitalized", the IRS could recharacterize Belco's loan to the CC as an injection of equity capital, instead of a loan.[58] This article assumes, however, that a loan by Belco to the CC will be treated as such under IRC Sec. 385.

Interest paid by the CC on a loan from Belco or another Belgian affiliate will not constitute FPHC income to the lender, because of the same country exception of IRC Sec. 954(c)(3)(A)(i). In addition, under the same type of rationale explained in Approach A, Prong 1 above, the interest income to the lending affiliate should constitute overall basket income to the lender. Also applying the same rationale used in Approach A, Prong 1, the income, when remitted by the lender to the ultimate U.S. parent company, will fall into the parent's overall income basket. Again, the U.S. parent company will be able to utilize the overall basket excess foreign tax credits to shield the income from residual U.S. tax.

Approach B, Prong 2 – Belgian analysis

The Belgian tax consequences to the CC would be similar to those explained in Approach B, Prong 1 above. As in Approach B, Prong 1, there is no Belgian tax deduction for the CC's interest payments, since the CC's notional tax is based on the CC's expenses, excluding personnel and financing charges. However, in this case, there would be no FWHT benefit to the lending affiliate, regardless of whether the borrowed funds were invested in new Belgian property or used to perform research and development activities, because the lending affiliate is a nonresident of Belgium. The interest income to the lending affiliate would be fully taxable in the affiliate's home country. However, unlike interest payments from a "normal" (non-CC) Belgian company to a nonresident of Belgium, there would be no interest withholding tax imposed by Belgium on the CC's interest payments. (This tax "break"

[continued on p. 390]

58. The application of IRC Sec. 385 can be a difficult task since no one factor controls the determination of whether financing to a related company is debt or equity. The difficulty is increased because IRC Sec. 385 itself provides only nebulous guidelines, and authorizes the Treasury Secretary to issue more detailed regulations. The IRS, after having proposed regulations on the matter in 1980, withdrew them in 1983. However, there is case law on the subject, such as *Post Corp. v. U.S.* 640 F.2d 1295 (1981 Ct.Cl.), which lists 16 factors which should be considered.

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The Proposed Belgian Tax Reform*

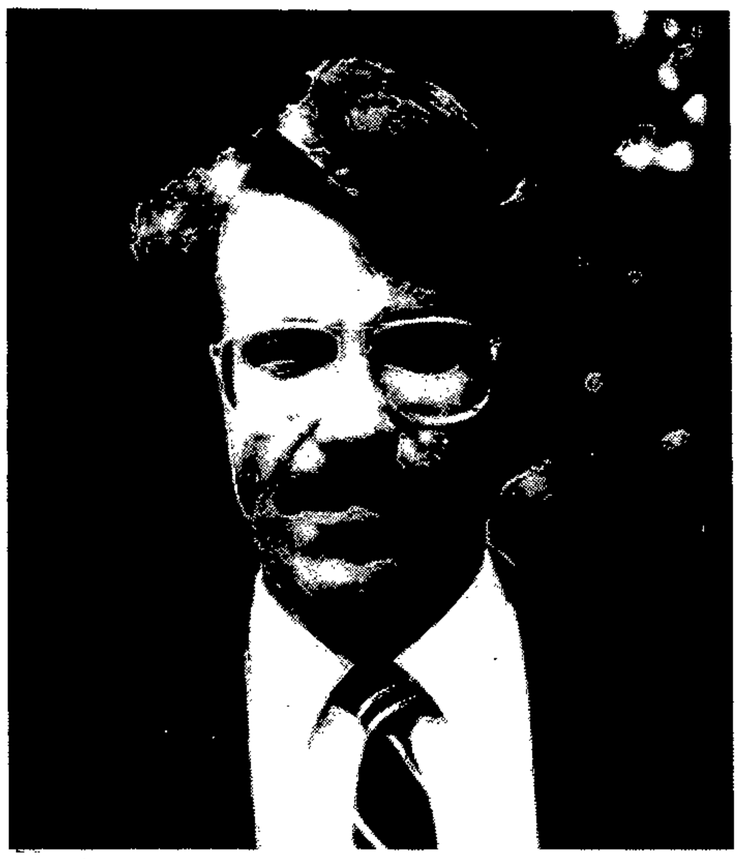
Aspects of International Taxation

By L.A. Denys

INTRODUCTION

On 11 February 1987 the Royal Commission for the Harmonization and Simplification of Taxation submitted its first Report to the Minister of Finance, who had created the Commission on 21 January 1986, shortly after the new Government had taken office. The Minister of Finance prolonged the Commission's mandate and ordered the Ministry of Finance to prepare legislative work in order to implement the recommendations of the Commission in 1988.

At the time this article was written, some basic policy decisions on the reform had to be taken by Government and Parliament, and the drafts for a comprehensive new Tax Code were still being elaborated. Therefore my contribution to this special issue on Belgium is limited to some comments on those basic options of the Commission which may affect international tax issues.



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CURRENT BELGIAN TAX SYSTEM

For a better understanding of the proposal a brief outline of the Belgian tax system is required.[1]

The current Belgian tax system was introduced in 1962,[2] shifting from a schedular system to a global system. Several partial reforms have been introduced since.[3]

At present Belgium has a rather obtuse personal income tax on world-wide income with a progressive rate structure, ranging from 25% to 72% (from 4,000,000 Bfrs. onward).[4] In some cases a rate exceeding 90% applies. There are special proportional rates for certain types of income such as : 16.5% for capital payments in lieu of pensions; 25% (final withholding tax) on interest, dividends and royalties (with a surcharge of 20% up to 47% if that income is not reinvested in qualifying investments); 33% on income other than professional or business income, etc. Income of married couples is aggregated.

Double taxation of corporate dividends received by individual shareholders is reduced by a tax credit that equals half of the corporate income tax. Shareholders may, however, opt for the imposition of a final withholding tax of 25%. Corporate shareholders may claim a dividend exemption of 95% (or 90% if they are "portfolio holding companies") of the dividends received; this also applies to foreign source dividends.

International double taxation is unilaterally reduced through a deduction of foreign tax and a partial reduction of taxes (a fixed tax credit of 15% for capital income, for individuals: a reduction to half the normal rate of income tax for earned income and business income; for companies a reduction to a quarter of the normal rate applies). Most tax treaties, however, provide for the exemption method and for the reduction of withholding taxes linked to the credit method.

As is the case in most Western countries, the tax system has become extremely complex due to a very substantial number of regulations on deductions, exemptions, tax reductions, etc., which in itself already justified the creation of the Royal Commission for the Harmonization and Simplification of Taxation.

* The author wishes to express his gratitude to Prof. Vanistendael, member of the Royal Commission for the Harmonization and Simplification of Taxation to whom he is very obliged for his willingness to revise the text and to formulate his very useful suggestions. Of course the author himself remains fully and solely responsible for the contents of his text.

1. For a recent survey of the tax system, see Tiberghien, A., *Belgian Income Taxes*, Kluwer, summer 1987.
2. See: "Survey of Belgian Income Taxes, A Study of the New Tax Reforms", 4 *European Taxation* (1964), 19 at 175-202.
3. Meanwhile, the Royal Commission decided to elaborate on specific international issues in an annex to its Report.
4. Approximately 100,000 U.S. dollar.

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BASIC OBJECTIVES AND PRINCIPLES OF THE TAX REFORM

The Commission postulates the following basic objectives and principles:

1. Budgetary neutrality

The overall tax burden should not increase, although an increase of indirect taxes and/or corporate taxes may seem necessary in order to reform the personal income tax regime adequately.

Especially the abolition of the aggregated taxation of married couples and to a lesser extent the reduction of the high marginal rates may be very costly.

2. Simplicity and transparency

A conditio sine qua non for the success of any tax reform is to impart to the taxpayers the feeling that the new tax system will be simple and comprehensible in its structure and application.

Heavy criticism has been formulated in business circles and by the liberal coalition government partners on the fact that the social security contributions (as parafiscal levies) have not been included in the reform. The Royal Commission for the Reform of the Social Security rejected such proposals in its Report of 29 August 1985.

Criticism has also been formulated on the fact that a substantially differentiated progressive rate structure continues to exist and that a drastic abolition of deductions and exemptions has not been proposed. Some tax experts criticize the fact that the Commission did not take the opportunity to reduce – for a substantial number of households – the obligation to file an annual tax return, with subsequent controls and assessments. The Commission argues however that this increases the democratic control on the public expenditure. Others criticize the complications resulting from the introduction of the credit mechanism imputation system for corporate tax and income tax. All this gives the impression that the Commission was too reluctant in pursuing the basic objective of simplicity and transparency.

3. Rule of law and stability

The confidence in the tax system requires guarantees on the procedural level and a special parliamentary majority for the change of basic tax regulations.

4. Principle of neutrality in taxation

The Commission reaffirms this basic principle and claims its application vis-à-vis marital status, source of income, economic decisions, international operations, finance techniques, consumption and savings, etc.

5. Justice

Another basic principle is the equal treatment of taxpayers horizontally – neither privileges nor exemptions – as well as vertically – global taxation at progressive rates, so that contributive capacity is taken into account. As such, the Commission apparently opposes the trend of recent years that exhibited a shift from global toward schedular taxation.

On the other hand, the Commission did consider the introduction of a *taxation system* based on *expenditure,* of which some characteristics are already present in the actual tax system (such as the Monory-deductions, the deduction for risk capital in innovation companies, the exempt dividends, exempt under Royal Decree 15/150, retirement accounts, deductibility of pension premiums, reinvestment exemption for capital gains, final withholding tax on dividends, interest and royalties, exemption for the surcharges on capital income if reinvested within two years, final withholding tax on rental income of newly built apartments, etc.).

The Commission, however, did not advocate this option because it requires a watertight control of all flows of capital and finances which, in its turn, requires an international approach.[5]

6. Harmonization

Harmonization with a view to:

- avoiding double taxation and proliferation of taxes originating from the different levels of the political scene (European, national, regional, provincial and municipal levels);
- avoiding double taxation on the corporate and on the shareholders' level;
- avoiding arbitrary application of tax legislation due to the variety of procedures;
- avoiding European fragmentation.

OUTLINE OF THE TAX REFORM PROPOSAL OF THE ROYAL COMMISSION AND SOME INTERNATIONAL CONSEQUENCES

The report of the Commission focuses on the following proposals:

I. Personal income tax

Introductory remark

An important change proposed by the Commission was the abolition of withholding taxes on Belgian-source interest, dividends and royalties received by non-resident individuals. The Commission did not propose any other substantial changes in the taxation of non-resident individuals so that they will continue to be taxed on other Belgian-source income according to the existing system, which largely corresponds with the regime of residents.

5. Vanistendael, F. (Member of The Royal Commission) in Editorial of *Algemeen Fiscaal Tijdschrift* (A.F.T.), April 1987, at 91.

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Structure and rates

The number of rates in the rate table will be reduced from 14 to 4, i.e. 30, 40, 50 and 60%, with an overall average limitation of 50%, and the abolition of all surcharges. The family situation will lead to the following exemptions: unmarried – 150,000 Bfrs.; couples – 225,000 Bfrs.; first two children – 45,000 Bfrs. each; each child thereafter – 112,500 Bfrs.; disabled children – double; other dependent persons – 45,000 Bfrs.

The Commission did not propose to take into account foreign source income to compute the tax rate applicable to Belgian income of non-residents.

Aggregated *taxation of married couples* should be abolished. For households with one earned income, 30% of the income will be taxed separately at the bottom of the progressive rates. Income from property will be taxed according to the marriage settlement or on a 50/50 split. I assume that equal treatment will be granted to *non-residents,* especially when they enjoy treaty protection.

Special rates will still apply:
- 16.5%, e.g. on capital compensation of a definite loss of income, long term capital gains taxable as business income, capital payments on the cessation of business activities;
- 25% final withholding tax on interest and on deemed interest of insurance contracts (including private pensions), and on capital in lieu of pensions;
- average rate of last year's normal income (e.g. golden handshakes, late payments, etc.). If no reference is available (e.g. in case of immigration), a 30% rate will apply.

In addition, the system of converting capital payments (in lieu of annual compensations) into fictitious annual taxable amounts in order to avoid excessive effects of the progression will be maintained (e.g. for capital compensation of a partial loss of income).

On the other hand, the Commission proposes to tax at normal progressive rates:
- periodic payments for the cessation of business activities; and
- periodic payments for the compensation of the reduction of business income.

Earned income

As far as *corporate directors* are concerned, the Commission proposes to introduce a less artificial distinction between the remuneration for their activities and their share in company profits, for which it proposes to allow the full tax credit as for dividends. This may to some extent be of particular interest to non-resident directors who will thus benefit from a more favourable tax regime than non-resident shareholders who are not entitled to the dividend tax credit. Complications may arise abroad if Belgium qualifies this income as a dividend (Treaty Art. 10 or 16 of the OECD Model Convention).

Income received *in lieu of earned income* (e.g. official pensions, pre-pensions, unemployment benefits) will no longer qualify for favourable treatment. Some types of welfare payment, however, will continue to be exempt (child allowances, study allowances).

With respect to *business income* the reduced rates (16.5% or 21.5% for corporations) on long term capital gains (i.e. for assets held for longer than 5 years) from business activities would also apply to intangible assets and land. The exemption for reinvested capital gains would be extended so as to limit taxation only to cases where the gains are not reinvested in the business activities.

Capital gains that recoup depreciation would be taxed at the full rate if realized within the first ten years. Losses should be carried forward indefinitely. Carry-back will only be introduced when a decision on the pertinent European Directive has been taken. However, the European Commission has already proposed a three-year carry-back (see Draft EEC Directive on Losses of 6 September 1984, as amended on 25 June 1985). The Commission has not recommended fundamental changes on the heavily criticized limitations on tax exempt provisions for bad debts.

Private pension payments (and premiums for pension schemes) to employees are no longer deductible (see infra: private pensions will no longer be taxable, except on a deemed interest of 4.5% or if a capital sum is paid, on the excess of the paid-in capital adjusted to inflation; the capital part will, however, have been subject to the business or corporate tax rate. The Commission does not recommend to introduce specific measures to take into account inflation (e.g. bookkeeping on replacement value) other than an adjustment of the investment deduction lower rate on long term capital gains and an adaptation of the existing, but outdated, inflation correction.

The advanced payment of estimated tax (accompanied by severe surcharges if later payment is made) will be replaced by a provisional assessment. In the first year of activities in Belgium probably no provisional assessment will take place.

Income from capital

Income from *real estate* would no longer be taxed on a deemed income on the national level, but only on the basis of real rental income (yet excluding depreciations, since capital gains are not taxed). Interest is deductible as a separate item (see infra). Losses (e.g. from repairs etc.) are carried forward. As a result of the abolition of the deemed income of the owner's occupied house, interest relating thereto will no longer be deductible; this would also apply to foreign real estate which is not rented. It is not clear what the rules may be in case of part-time rental.

As the progressive global taxation is to be restored, withholding taxes on *dividends* would no longer be final. For *interest* (including payments from pension schemes) and *royalties* the 25% withholding tax would – for pragmatic reasons – remain final. This manifest

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discrimination between risk capital and loan financing has already raised wide criticism.
Non-residents would enjoy full *exemption* of these *withholding taxes.*
Dividend income received by residents will qualify for full tax credit for corporation tax. It is not yet clear to what extent foreign shareholders could claim the tax credit.

A *capital gains* tax on private shares will be introduced to compensate lower corporate tax on reserved profits of small corporations. The capital gains tax on land (33% or 16.5%) and on substantial participations (16.5%) will be abolished. In respect of tax deferred income from capital (zerobonds, etc.) no changes have been proposed.

Interest relating to property investments will be deductible from all property income (but may not create losses which could otherwise be carried forward). As indicated, this will no longer apply for owner occupied dwellings.

Similarly, as interest received will be subject to a 25% final withholding tax, interest related to gross real property income will no longer be deductible from such income, nor for the computation of the tax basis of the withholding tax.

Deductions

All *savings or investment deductions* (including private employment pension schemes, stock options, investments in innovation companies, and the newly introduced retirement accounts) will be replaced by one limited lump-sum deduction of 50,000 Bfrs. for the spouse. Private pensions will only be taxed as income from investment (i.e. 25% on a deemed interest of 4.5% or on the excess of the paid-in capital (adjusted to inflation) and the so-called profit sharings. This may make Belgium a tax haven for retired people.

It is obvious that such drastic measures may encourage international companies to organize the position of their international management personnel in such a way that pension premiums are deductible from profits realized outside Belgium and/or from income earned and taxed abroad (and lightly taxed in Belgium at the moment of distribution). Belgian business circles highly criticize this proposal.

Alimony will be fully deductible and correspondingly taxable (instead of 80%). Capital payments in lieu of alimony will be converted into fictitious annual payments. Non-resident beneficiaries will be subject to a withholding tax, but tax treaties normally provide for taxation in the home country.

Foreign source income

Foreign source income from *Non-Treaty Countries* will only enjoy a *credit for the tax actually paid* abroad by the taxpayer himself, and only proportional to the income taxed in Belgium. The Commission also recommends that only after the definitive assessment has taken place abroad, may the credit be granted (or refunded). The *reduction of the income tax rate* to half (for individuals) or a quarter (for companies) of the normal rate should thus be abolished. However, since non-treaty countries are not the major commercial partners of Belgium, the Commission considered it not important to eliminate double taxation in an exact manner. Therefore the Commission proposes the following simplification to the general rule:

Full exemption for all income from *real estate, earned and business income* and income other than the income from (movable) capital, if the income originates from a non-treaty country with *a taxation comparable* to the Belgian tax (including a tax burden on the corporate and shareholders' level that equals the Belgian tax burden). If taxation is not comparable, we assume that the general rule (exact credit) will apply. This exemption will not apply to income treaty countries, even if double taxation is not fully avoided.

Although *income from movable capital* will be treated in conjunction with the corporate tax system, foreign source interest, royalties, etc. taxed abroad will be subject to Belgian income tax, against which a fixed credit (possibly at the rate of 15%) will be available, but only on the net taxable amount (less interest or royalties paid). It is not yet clear how this would be applied to foreign source dividends. From the Report of the Royal Commission it seems as if all foreign source movable capital income would be taxable at the 25% final tax rate, as is the case now. If so, it is unlikely that a tax credit for foreign withholding taxes will be available. If dividends from foreign sources are to be taxed at the full progressive rate (like domestic dividends) in Belgium, the tax credit will be limited to effectively paid withholding tax (not the underlying corporate tax).

Foreign source income originating from *treaty countries* will either be taxed at normal rates, or exempt with progression, or taxed with credit imputation, as the treaties determine. It is not yet clear what rules will apply to dividends from treaty countries (e.g. under the provisions of the French–Belgian tax treaty the recipient of French source dividends may opt between applying the fixed 15% credit and the tax credit which is normally only available with respect to Belgian source dividends).

II. Corporate taxation

The Commission has not studied corporate taxation with a view of proposing a tax reform. As regards the structure it basically refers to the proposal formulated by a Working Group of the High Council for Taxation, an advisory board to the Minister of Finance, of which the prominent persons from the universities, the business world and the Ministry of Finance are members. The Working Group's proposal substantially deviates from a Draft EEC Directive on Company Taxation and Withholding Taxes on Dividends of 23 July 1975. This draft, subject to some adjustments as to the average European rates, seems to gain a certain revival now that the German-Dutch withholding tax dispute

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loses a great deal of interest due to the proposed German tax reform.[6] The aspects of personal income tax reform relating to business income as indicated above obviously concern corporations as well.

Structure and rates

The introduction of a full tax credit for shareholders will entail the levy of a *compensatory tax* on distributions which were not fully taxed at the corporate level (e.g. in the case of the reduced capital gains tax investment deductions, the reduced rate for small corporations). This tax will compensate the Treasury for any imputation credit granted to shareholders who benefit from a tax credit with respect to income distributed by a company which has not been subject to the full rate of Belgian corporate income tax.

This compensatory levy will not apply to profits realized in foreign (treaty) countries (i.e. permanent establishments), nor to dividends that are deductible (e.g. on the basis of the 1982 Royal Decree 15-150, the Innovation Companies).

In order to further investment of risk capital in small corporations, it is proposed to continue the application of reduced corporate tax rates on retained profits. However, in order to avoid indirect tax exempt realization of these retained profits a new capital gains tax on the sale of private shareholdings is suggested. It is not clear whether this capital gains tax will entail an exemption of the compensatory tax on the distribution of those retained profits, and if the same would apply to corporate shareholders which realize capital gains on shares partly representing exempt retain profits.

The Commission is studying the possibility of not applying the compensatory levy to dividends distributed to foreign shareholders from profits taxed abroad, including foreign source dividends. This idea is to be understood in conjunction with the aim of abolishing withholding taxes on outgoing dividends, interest and royalties (see supra: Income from capital). The Commission also criticized the system of non-deductible profit sharing of directors and proposes a full tax credit.

Although the Commission advocates the abolition of the discrimination between loan financing and equity financing and therefore proposes a full tax credit, it re-introduces the discrimination by limiting the final tax on income from non-risk capital to a 25% withholding tax. Added to the proposed abolition of withholding tax for non-residents, this may seriously affect the finance structure of Belgian subsidiaries of foreign companies, since no debt-equity ratios are proposed.

Dividends received by corporate shareholders would also carry the tax credit. It is not yet decided whether this full credit mechanism would also apply to foreign source dividends. Most treaties refer to the existing international exemption method.

Unless the credit method is accompanied by far-reaching complicated rules (underlying foreign tax, rewritten foreign profits according to Belgian rules, exchange of information, etc.), it would further the concentration of shares in foreign holding companies that enjoy the exemption method on dividends received. The Minister of Finance, in answer to a Parliamentary Question of January 1986, rejected the idea of introducing a kind of subpart F legislation because of its complexity and its limited application. There are indeed already too few international corporations that have Belgium as their home country.

Corporate tax rates should be fixed in such a way that, added to the withholding tax, the total tax burden approximates the marginal personal income tax rate. If the corporate tax is maintained at 43% and the withholding tax at a level of 25%, the total burden would be a maximum of 57.25% (marginal personal income tax rate is 60%).

The Commission proposes to maintain the reduced rates (or even a tax deferral if they are reinvested) on long term capital gains, with a claw-back of depreciation at the full rate in the first 10 years (see supra: business income).

It seems appropriate to question why the Commission did not consider to extend the dividend exemption or full dividend tax credit to the capital gains on participations (as, e.g. in the Netherlands and Luxembourg – for other than holding companies). Would this not be in line with the aim of avoiding double taxation (i.e. on corporate profits and indirectly on the same profits through the gains on the share holding)? The new compensatory capital gains tax for individuals is also an "extension" of the corporation tax.

Tax incentives

The Commission holds the opinion that the actual regulations for depreciation (straight-line, declining balance or accelerated) combined with the investment deduction are satisfactory; yet it recommends to introduce – for bad economic situations such as high inflation – additional accelerated depreciation.

Dividend exemption

As indicated above, the exemption of 95% or 90% (for intercorporate dividends) could be replaced by a tax credit mechanism of which very little is known at this moment.

In general, such a credit mechanism may have the advantage that the Belgian holding company that finances the capital of its subsidiary by loans may recover the taxes paid by the subsidiary through a deduction of interest from the dividends received.

It is not yet clear whether the credit would apply to foreign source dividends and especially whether only withholding taxes or also underlying corporate tax would be creditable. If so, Belgium would follow the system known in some other countries. This proposal would certainly complicate the tax legislation

6. This dispute concerns the exemption of dividends paid by a German subsidiary to its Dutch parent corporation from German withholding tax.

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(simplified especially for a matter relatively similar in 1973). If the reform – as for personal income taxation – distinguished between dividends from treaty countries for which an exemption would continue to apply, and from other sources, an even more complicated tax legislation would be the result, and thus also an increasing interest for treaty shopping. Yet, many treaties provide for non-discrimination between dividends from domestic sources and from treaty countries.

However, it seems to me that the open economy of a small country like Belgium is better off with an exemption method for foreign dividends, especially within the EEC, where the Commission proposed the exemption method as the European solution for avoiding double taxation (see Drafts mentioned above).

Foreign source income

The current fixed tax credit of 15% of capital income (interest, royalties, dividends from non-permanent participations) on the gross amount – irrespective of the funding costs – seems to be too costly and requires a change to limit the credit to tax actually paid abroad and to the net taxable income. This measure may seriously affect the international profits of Belgian banks and financial institutions and may require the re-negotiation of tax treaties. As indicated above (dividend exemption), it is yet unclear whether this would also apply to foreign dividends from "permanent participations".[7]

Group consolidation

The Commission does not formulate proposals, but defers the matter until a regulation in the field of accountancy has been introduced. In doing so, the Commission disregards the 7th EEC Company Law Directive on the Consolidated Accountants of 13 June 1983, which is to be implemented before January 1988.

Liquidation of companies

The actual tax deferral in the course of liquidation will be replaced by the normal corporate tax regime. The distribution tax rate (17.5% to 30%) will be aligned to the withholding tax rate of 25%. In most treaties, Belgium reserved the right not to reduce the liquidation distribution tax.

International mergers

In this area, too, the Royal Commission defers a reform – until a solution is found – to the European level. The European Commission proposed a Draft EEC Directive on Mergers and Acquisitions on 15 January 1969. This draft, as already mentioned, seems to appear before the footlights as the German tax reform pursues and the Draft EEC Directive on Parent-Subsidiary Relations of January 1969 no longer runs up against the Dutch–German disputes on the withholding taxes on dividends (see also the third EEC Company Law Directive concerning the division of public limited liability companies of 17 December 1982).

Foreign companies

No special attention is given to the tax status of foreign companies with permanent establishments in Belgium. An implicit abolition of the taxation of lump-sum minimum tax bases for foreign companies results from the proposed changes in tax procedure. The Commission, however, intends to elaborate on this subject.

Companies with special tax status

The existence of so-called "T-zone companies", "Reconversion companies", "Innovation companies" and "Coordination centers", which receive privileged tax treatment, does not fit into the general objectives of the tax reform. Yet, the Commission limits its comments to the recommendation of a harmonization of the tax exemptions.

Non-profit organizations

Individual and corporate taxpayers may deduct within certain limits gifts to recognized non-profit organizations. The Commission proposes to replace the actual system of final withholding taxes on property income and exemption for business income for organizations which engage in specific activities. All revenue of the recognized organizations would become subject to corporate tax except to the extent the revenue is used for the non-economic activities, nor if the revenue is raised on some specific activities (occasional actions).

It is obvious that substantial problems will arise if such system (where exemption applies on the basis of the use of the revenue) was to apply to non-resident non-profit organizations which actually have large real estate investments in Belgium.

The Commission also proposes an alternative reform which is limited to an adjustment of the actual regime:

- Real estate would continue to be taxed by local authorities on the basis of the deemed rental income. The domestic tax law would determine the criteria for exemptions for cultural, philosophical, scientific, religious, etc., reasons.
- Rental income would be taxed on the basis of real net income (excluding amortizations) unless the tenant is a private individual and no written lease contract is available, in which case deemed income is taxable.
- The tax rate could be increased from 20% to 25% (on a possibly broader taxable basis!).

Also this new regime would substantially increase the tax burden on real estate investments of non-resident, non-profit organizations.

The Commission proposes to extend the scope of application of the lump-sum taxation of approximately 200% on income paid to unidentified persons, to all such payments by any public authority (this actually applies to all corporations and non-profit organizations).

7. "Permanent participation" generally means that the recipient company has held the shares during the entire financial year in which the dividend is received.

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Undoubtedly, the latter measure added to the proposal to subject all non-profit organizations to the control of the corporate tax inspector increases in an overwhelming way the controlling authority of the Minister of Finance in areas which are closely related to the fundamental rights of individuals.

III. Indirect taxation

The Working Group of the High Council for Taxation (to which the Commission refers) noted the shift of the proportion of indirect taxes into the total budget from 1970 (54%) to 1985 (38.8%). In addition, it noted that vis-à-vis the other European countries Belgium (and the Netherlands) have the lowest percentage. Furthermore the Belgian VAT represents a relatively higher percentage of total indirect tax revenue than other European countries.

Taking into account the general orientation of the European Communities in this area the Working Group recommends the following reforms:

- A simplification by reducing the number of VAT rates to three, and by a reduction of the number of rates in other indirect taxes.
  The seven rates, varying from 1% to 33%, would be replaced by 6%, 20% and 25%. (The Commission also suggests to maintain the zero and 1% rates to a limited extent.)
  In general these proposals fit into the European endeavours to realize the internal market in 1992, and can thus be welcomed from the international point of view. Belgian business circles, however, fear that the competitive position of Belgium will be harmed.
- An increase of indirect taxes, and especially excise duties, in order to bring them on the average European level, for alcohol, tobacco and mineral oils. Other excise duties on coffee, sugar and non-alcoholic drinks should be abolished.

IV. Reform of the procedures

The Commission proposes to create one code of tax procedures applicable to all procedures, with the exception of the local taxes, for which a recent harmonization has been introduced. Apart from the harmonization, the proposals try to simplify the procedures by referring to the general principles of tax procedure, and by referring to the Code of Judicial Procedures, which is the code that applies to all court proceedings in Belgium.

In brief, the Commission proposes the following:

- The introduction of a preliminary ruling procedure.
- The principle that all taxes should be levied on the basis of a tax return.
- All taxes should be levied through an explicit assessment.
- Introduction of three types of tax controls: summary control, bookkeeping control and thorough verifications.
- Introduction of tax reductions when books are kept by an approved bookkeeping and administration centre.
- Redefinition of the investigating powers of the Tax Administration.
- Introduction of the general principle of law that protects privacy in tax matters and the general principle that requires good administration from the Tax Authorities.
- Abolition of taxation on the basis of comparisons, including the minimum tax on foreign companies with a permanent establishment in Belgium.
- Unification of the time limits for taxation (in general 18 months; in case of insufficiencies in tax returns: 3 years, in case of fraud: 6 years).
- A rather revolutionary proposal consists in the establishment of one single Directorate for Tax Disputes, which acts as an independent Court of original jurisdiction (Compare the Board of Tax Appeals or Tax Court in the U.S.A.) for all tax procedures. This directorate would act independently.
- The rules concerning the claimability, statutes of limitation interest, prosecutions and the rights and privileges of The Treasury.
- Penalties and sanctions in tax matters should be aligned to the general penal law, including the possibility to propose transactions.
- The Commission is of the opinion that tax secrecy is to be extended to tax consultants.

Some of the proposals of the Royal Commission appear to prompt substantial criticism from the Tax Administrations. As such, this probably indicates that the Commission has hit the heart of the matter.

Although many other European countries have introduced special rules regarding the international exchange of information and other *international procedures,* the Commission has not considered reforms in this area.

Neither did the Commission formulate an opinion on the Draft EEC Directive on Adjustment of Profit Transfers of 29 November 1976 nor on the Draft European Convention on Mutual Administrative Assistance in Tax Matters.

Both proposals hardly contain any procedural safeguards in which the respect of legitimate interests of taxpayers is involved.

CONCLUDING OBSERVATIONS

The hope or the fear of many people in Belgium that the U.S. Tax Reform 1986 may cause a drastic change in Belgium's Tax System appears to be an illusion, or only a nightmare, at least if the politicians follow the recommendations of the Royal Commission.

The less "spectacular" changes – at least in the view of the general public – such as those in the field of corporate and shareholders' taxation or in the field of tax procedures, may have a far-reaching impact on the Belgian tax scene.

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As usual, hardly any attention has been given to the international issues of taxation; this may seem surprising for a small country like Belgium, with an open economy and the possibility of playing a key role in central Europe.

The abolition of withholding taxes for non-residents, however, testifies to growing consciousness of the importance of a free European Capital Market.

It is hoped that the legislature will take up its responsibility and use this opportunity, after some years of experimenting with international sophisticated initiatives, to set up a stable and friendly international tax climate.

[continued from p. 382]

may be of little importance if the CC is paying interest to an affiliate resident in a country which normally would allow a tax credit for Belgian withholding taxes, such as France.)[59]

Approach B, Prong 2 – U.S. analysis

The U.S. analysis of the interest paid by the CC on these loans is very similar to the analysis of interest paid by non-Belgian, non-U.S. affiliates to the CC under Approach A, Prong 2 above. However, in this case, it is the non-Belgian, non-U.S. affiliate (the lender) which generates Subpart F income (rather than the CC). Nonetheless, again the interest received by the non-Belgian affiliate should be categorized as overall basket income all the way up to USCo.

In one sense, the application of IRC Sec. 904(d) is somewhat simpler in this case than in Approach A, Prong 2. Unlike interest paid by non-Belgian affiliates to the CC, there is no interest withholding tax imposed on interest paid by the CC to a non-Belgian affiliate. As such, the high withholding tax interest rules of IRC Sec. 904(d)(2)(C) automatically exclude the interest from this one separate basket.

CONCLUSION

The U.S. Tax Reform Act of 1986 will have a significant impact on the tax planning of U.S.-based multinational corporations. One important aspect of the Act will be the reduction in the highest marginal U.S. corporate tax rate from 46% to 34%. This reduction may result in many U.S.-based multinationals generating excess, perhaps useless, foreign tax credits. To the extent possible, U.S. multinationals will be placing greater emphasis on making their non-U.S. operations more tax efficient, thus reducing their effective non-U.S. tax rate.

One possible tax efficiency measure that merits consideration is the Belgian Coordination Center. Structured properly, a Belgian subsidiary can utilize the CC legislation to reduce the effective foreign tax rate of a multinational group of companies. A key consideration in structuring a CC will be the new separate income basket limitations of IRC Sec. 904. Generally speaking, however, a CC can be established in such a way as to avoid recharacterizing overall basket income (where excess foreign tax credits will likely be available to offset any residual U.S. income tax) as income in a separate basket such as the passive basket (where excess foreign tax credits will likely not be available). The creation of a CC may give rise to additional immediately taxable, Subpart F income to the U.S. multinational. However, this should be of no concern if the income remains in the overall income basket and the multinational has excess foreign tax credits in that basket.

As a final caveat, while the establishment of a CC may prove attractive to many multinational corporations, caution should be exercised with respect to certain areas of the new U.S. law. There are as yet some unanswered questions about the application of the Act to Belgian CCs, such as the breadth of the new PFIC provisions of IRC Secs. 1291-1297. Clarification of some of these uncertainties should be forthcoming in the near future. At the time this article was submitted for final printing, the U.S. Congress was considering passage of the Technical Corrections Bill of 1987, and the Treasury Department had indicated an intention to release proposed regulations on some of the Act's more important provisions by the end of 1987.

59. Art. 16(3) of the France–Belgium Income Tax Treaty.

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BELGIUM:

Some Special Aspects of Foreign Source Profits and Losses in Corporate Income Taxation

By H. Siebens

The tax treatment discussed in this article relates to profits and losses realized in a permanent establishment in a country other than the country of residence.

Belgian corporate income tax legislation contains special rules relating to the treatment of foreign source income or loss to be included in the income of a company. The general principle is that foreign *losses* immediately reduce profits from any other source. Foreign source *profits*, on the other hand, are either completely exempt if realized in a country with which Belgium has concluded a treaty to avoid double taxation, or are taxed at 10.75% (¼ of the normal rate of 43%) if realized in a non-treaty country.

For treaty countries, the treaty rules will govern the jurisdictional rules under which the source country may tax income generated in that country and the exemption in the residence country is granted regardless of the fact whether the income is subject to tax in the source country or not.[1] The reduced rate of 10.75%, for income generated in a non-treaty country will, on the other hand, only be applicable if evidence can be submitted that those profits were earned and taxed in the source country.[2]

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DETERMINATION OF FOREIGN SOURCE EARNINGS

Foreign source earnings are, as well for accounting as for tax purposes, taken into account for the determination of total earnings of a company. The determination of taxable income is based on the balance sheet and profits and loss account established in accordance with Belgian legislation and approved by the General Assembly of Shareholders. Any possible differences between Belgian legislation and the legislation of the source state are disregarded. Certain expenses will, for the determination of taxable income (including foreign profits), not be treated as deductible expenses.

Examples are commission fees paid to beneficiaries whose names are not revealed, certain excess depreciation on cars, and any other non-deductible expenses under Belgian legislation. Foreign taxes, unlike Belgian corporate income tax, are deductible.

As is the case in most other countries, Belgium will not necessarily accept the determination of foreign earnings as they were established for foreign income tax purposes, but will apply Belgian rules for the determination of taxable profits.

The result may be that the profit computation under the Belgian rules may show a foreign source profit, while under the source country legislation a loss is incurred and vice-versa.

ALLOCATION OF PROFITS ACCORDING TO SOURCE

Profits which have been determined for each establishment in accordance with the above rules, are divided up into 3 categories of sources.
- Belgian source profits;
- treaty country profits;
- non-treaty country profits.

As a first step, the law[3] requires the setting off of profits and losses from the same source. This means that all profits and losses from the treaty countries must be aggregated.

1. "Source country" in this article means the country from which the income is derived. Residence country is the country where the recipient of the income is established.
2. The Supreme Court in the "Sidro" case on 15 September 1970 defined the terms "earned and taxed". The principle of formal taxability is hereafter always retained. See Afschrift, Th. *Journal de Droit Fiscal* March-April 1980, at 65.
3. Royal Decree (4 March 1965) implementing the Income Tax Code, Art. 66.

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The same aggregation and setting off has to be done for profits and losses from non-treaty countries. The law,[4] moreover, for the determination of the final result imposes the following order for setting off profits and losses:

1. Losses sustained in a treaty country are first imputed on profits exempt from tax by virtue of a tax treaty. If these profits are insufficient to absorb these losses the latter are imputed on profits taxed at a reduced rate (i.e. foreign source profits derived from a non-treaty country) and if there is any balance of loss they are finally imputed on Belgian source profits;
2. Losses sustained in a non-treaty country (for which profits are taxed at reduced rates) are first imputed on profits from other non-treaty countries, then on profits exempt by virtue of a treaty and finally on Belgian source profits;
3. Losses sustained in Belgium are first imputed on Belgian source profits, then on profits derived in a non-treaty country (which are taxed at a reduced rate), and finally on profits exempt by virtue of a treaty.

This order is not based on any scientific or economic principle, but is purely an arbitrary technique prescribed by the law which can lead to illogical results. The compulsory imputation rules, among other things, have as a result that foreign source profits, whether derived from a treaty or a non-treaty country are set off against Belgian losses whereby any loss carry-over may be lost. Foreign losses, on the other hand, reduce immediately Belgian profits even if the source country does not permit a loss carry-over.

DOUBLE DEDUCTION OF LOSSES

Belgian internal law permits the "double deduction" of foreign losses, i.e. a deduction from foreign source profit and simultaneously from Belgian source profits. If the source country permits the deduction of losses, it may be possible for foreign losses to reduce foreign source income by virtue of the foreign legislation and at the same time they may reduce Belgian source income by virtue of Belgian legislation.

This "double deduction" of losses will, however, not be "complete" in case of a non-treaty country loss, because profits of later years realized in those countries will be taxed at 10.75%. See example in the right hand column.

Belgian double tax treaties,[5] however, contain a provision to eliminate this double deduction of losses by including a provision to the effect that Belgium will *not* exempt from Belgian income tax any foreign source income derived through a permanent establishment located in the treaty country to the extent that in preceding years losses have been incurred through that permanent establishment which have (i) been deducted from Belgian source income and (ii) which have been carried forward and been deducted for purposes of income tax in the treaty country. This provision operates efficiently if loss and future profits calculated in accordance with the different rules of each respective country correspond with each other. Problems occur if differing results are obtained in the respective countries.

Year 1:	Profit in Belgium	200	
	Loss in non-treaty country	(100)	
	World-wide income	100	
	Tax due: – in Belgium 100 × 43%		= 43
	– in non-treaty country		0
	– Total tax due		43
Year 2:	Profit in Belgium		200
	Profit in non-treaty country	200	
	Loss carry-over	(100)	
			100
	World-wide income		400*

* The loss has already been deducted in Belgium and the foreign profit, according to Belgian rules, is 200. The foreign profit set off in the source country because of the loss carry-over is therefore taxable in Belgium, albeit at 10.75%.

Tax due: – in Belgium	200 × 43%	= 86
	200 × 10.75%	= 21.5
		107.5
– in the treaty country 100 × 43%		= 43
– Total tax due		150.5

Assume for instance that in 1986 earnings of a Dutch permanent establishment of a Belgian company calculated in accordance with Dutch tax law show a profit, but that a loss is incurred when those profits are computed in accordance with Belgian rules (for instance because of the application of the Belgian provisions regarding accelerated depreciation). Assume further that in 1987 a profit is obtained in the Netherlands as well as in Belgium.

Art. 24(2)(e)[6] of the Belgian–Dutch income tax treaty will in that case not be applicable because no double deduction of losses will have occurred since the Dutch permanent establishment will, for Dutch income tax purposes, have obtained a profit in both years.

A special feature of this provision to avoid the double deduction of losses is that Belgium will take into account the rules on the deduction of losses of the other treaty partner. Extremely complex problems thereby result with countries such as the Netherlands which permit a 3-year carry-back of losses.[7]

4. Id.
5. Except the treaty with Yugoslavia.
6. Art. 24(2)(e) of the Belgian–Dutch tax treaty provides (unofficial translation published in *Supplementary Service to European Taxation):*
   (e) Where, in accordance with the Belgian law, losses sustained by a permanent establishment in the Netherlands of an enterprise resident in Belgium are effectively deducted from the profits of this enterprise for purposes of the taxation in Belgium, then the exemption provided for in subparagraph (a) shall not apply to profits realized in other tax periods which can be allocated to the permanent establishment to the extent that those profits are not taxed in the Netherlands on account of a carry-over of those losses.
7. Administrative Circular 8/3/82,Ci R9 Div./317361, *Bulletin der Belastingen (BdB)* 1982, No. 606, at 946 with supplements in *BdB* 1982, No. 612, at 2827 and *BdB* 1983, No. 622, at 2773. See also Defoort, J. in *Fiscoloog Internationaal* 38 of 15 January 1987 at 7.

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Problems will also occur if the taxable profits are not the same in both countries. Assume for instance that the earnings of a French permanent establishment calculated in accordance with French rules reveal a loss of 80, while Belgian rules only show a loss of 60. Belgium will in such a case permit the immediate deduction from Belgian profits of the French loss of 60. Assume further that profits of the French permanent establishment in the subsequent year equal 80. Belgium will in such case in accordance with Art. 19(A)(para. 3) of the Belgian–French tax treaty not give an exemption because this 60 reduced Belgian profits in a prior year. The exemption of the excess of 20 will on the other hand have to be granted notwithstanding that this 20 has not been subject to tax because of the loss carry-over in France.

SETTING OFF OF FOREIGN PROFITS WITH BELGIAN LOSSES IN A TREATY SITUATION

This problem has already been touched upon. Profits of a treaty country are immediately set off against Belgian losses whereby the loss deduction and loss carry-over is lost to the extent of this setting off.

This problem has resulted in many controversies as a result of a Supreme Court decision of 29 June 1984.[8] Contrary to the Court of Appeals of Antwerp which on 6 June 1983[9] squashed the abovementioned administrative position, the Supreme Court ruled that this position was not in contradiction with the law or the treaty rules.

Briefly summarized the problem was as follows:

A Belgian company realized a loss for tax purposes in its Belgian operations, but made a profit in its permanent establishment in the Netherlands.

The loss imputation rules[10] had as an effect that the profit of the Dutch permanent establishment was set off against the Belgian loss and only the excess was treated as a loss that could be carried forward.

The loss carry-over was consequently lost to the extent of the Dutch profits. The Court of Appeals concluded that the above setting off eliminated the exemption of the Dutch profits provided in Arts. 7 and 24(2)(1) of the Belgian–Dutch tax treaty. Moreover, the Court stressed that if an internal rule was in conflict with a treaty rule, the treaty rule had to prevail. This position was not completely new, since the Supreme Court in a comparable problem in 1970 under the old Belgian–French treaty also tried to mitigate this so-called "double taxation".[11]

Mr. H.R. Depret[12] has come to the following conclusion in relation to this problem:

> Setting off losses sustained by a Belgian company with profits realized in a permanent establishment abroad and exempt by virtue of a tax treaty is not in conformity with treaty law if no other measure is taken to eliminate or reduce the international double taxation that results from this practice.

J. Defoort[13] on the other hand reviews the profit and loss imputation rules in light of the OECD Model Treaty and comes to the following conclusion:

> Belgian profits of a later accounting year which normally would be set off with the loss carry-over are consequently being taxed because the foreign profits neutralise the loss carry-over. This latter is clearly in conflict with Art. 23A (para. 1) of the OECD Model which, after stating that the country of residence must exempt foreign-source income, provides in what way this income may still be taken into account. Art. 23A (para. 1), 2nd sentence, of the Model provides in this respect that those foreign profits may only be taken into account in order to determine the rate of tax on non-exempt income.

Prof. Claeys-Boúúaert, finally,[14] calls the result of the setting off rules "anomalous" as the losses of the Belgian head office are never deducted from taxable profits insofar as they are set off by foreign profits. All those comments date, however, from before the recent Supreme Court Case of 29 June 1984, referred to above.

The Court concluded in that case that the treaty rules were not violated and used the following reasoning to support this position:

> Taking into account that Art. 7 of the treaty between Belgium and the Netherlands provides that: profits of an enterprise of one of the States are only taxable in that State unless the enterprise carries on business in the other 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 the permanent establishment;
>
> Taking further into account that Art. 24(2)(para. 1) of that treaty provides that: Profits and income (. . .) which may be taxed in the Netherlands in accordance with the foregoing articles, are exempt from tax in Belgium. This exemption does not prevent Belgium from taking into account the thus exempted profits and income for the determination of the rate of tax.
>
> And while Art. 24(2)(para. e) of the treaty prevents the double deduction of losses sustained in the Netherlands;
>
> From all these provisions can be deducted that the treaty does not govern the taxable base, but only provides that certain income is exempted from tax. It therefore has to be deciced that the treaty does not prevent Belgium from taking into consideration, for the determination of the taxable base, profits derived in the Netherlands and taking those profits consequently into account in the amount with which the Belgian losses have to be reduced (. . .).

8. Supreme Court, decision of 29 June 1984, *Algemeen Fiscaal Tijdschrift (AFT)* Nov. 1984, at 194; id. Court of Appeals Mons, decision of 15 May 1986, *Fiscale Jurisprudentie/Jurisprudence Fiscale (FJF)* No. 86/191.
9. Court of Appeals of Antwerp, decision of 6 June 1983, *AFT* October 1983, at 209.
10. See note 3.
11. Decision of the Supreme Court of 10 November 1970, *Journal Pratique du Droit Fiscal* 1971, at 16.
12. Depret, H.R. in *Réflexions offertes à Paul Sibille ("Réflexions")* at 427 and 439.
13. Defoort, J., *Fiskofoon* No. 43, February 1984, at 12.
14. Claeys-Boúúaert, I., *Tijdschrift voor Notarissen*– 1980, No. 7/8 No. 22.

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Important in this motivation is the statement that treaties regulate the *exemption* of certain profits but do not govern the determination of the taxable base. This important argument apparently was missed by L. Hinnekens in his rather sharp comment on the case.[15] His interpretation that the express mentioning in the Exemption Article of "the progression principle" and the provision on prevention of double deduction of losses are to be read as exceptions to the rule of "complete exemption" is not convincing.

These two provisions precisely strengthen the principle that the exemption clause in the treaties has to be read in its limited significance. The progression principle and the prevention of double deduction of losses are provisions which do not influence the exemption, but govern solely the determination of the taxable base.

Surprising, however, is the fact that in the argumentation of both the Court and some commentators causes and results are mixed.

A simple example of the problem shows the following:

Year 1:	loss in Belgium	100
	profit P.E. in the Netherlands	80
	loss carry-over	20
Year 2:	profit in Belgium	200
	profit in the Netherlands	P.M.
	deduct: loss carry-over	(20)
	Taxable	180

The exemption of the Dutch profits in year 1 is perfectly respected since Belgium does not tax the Dutch profits (no tax is levied at all). In year 2 it appears that of the Belgian loss of year 1 only 20 is set off due to the loss carry-over. It is consequently not the Dutch profits that are influenced, but the Belgian loss carry-over. The problem therefore exclusively relates to the internal Belgian legislation on the deduction of losses which is not affected by the treaty (the treaty only governs the exemption and not the taxable base).

Computation of taxable profit in Belgium is still governed by a legislative approach which is only hesitantly abandoned.[16] Especially the fact that taxes are assessed annually (i.e. the "annuality" of taxation principle) plays an important role herein. The rules on deduction of losses will therefore, as long as computation of taxable profit is dominated by the profits realized in a particular period (i.e. the "annuality" of taxation principle), have to be construed restrictively. Taking into account losses of prior years will consequently only be possible if an explicit provision of the law permits this.

Such provision which will form an exception to the general rule of annuality of taxation will, moreover, have to be construed restrictively. If this restrictive interpretation is mixed with technical rules relating to the imputation and exemption, illogical results will appear which may also occur in a non-treaty situation.[17]

This problem may therefore not be approached with the economic argument that over "a number of years" there is economic double taxation because of the limitation on the deductibility of losses. Such an approach would only be acceptable if an unlimited carry-over of all losses was permitted. The time limitation on the deductibility of the losses thwarts every economic approach.

LEGAL AND FISCAL DEFINITION OF THE TERM PERMANENT ESTABLISHMENT

A Belgian permanent establishment of a non-resident company, as is the case in most other countries, is treated as a separate taxpayer. Transactions between the head office and the establishment therefore have to be conducted at arm's length. The qualification of separate taxpayer is, however, not followed in the reverse case where the head office is in Belgium and the establishment abroad. The taxable result is in that case computed on a world-wide basis and elimination or reduction of double taxation is achieved with accounting techniques.

This double qualification inevitably leads to various complications, of which some deserve special attention.

INTEREST

Neither a positive nor a negative interest may be taken into account as remuneration of capital when profits of a foreign permanent establishment are computed. The same interest deduction is also refused in the reverse case notwithstanding that this is an exception to the qualification of the separate taxpayer and arm's length principles. Moreover, problems will occur with the qualification of domestic or foreign source income of a financial nature and, more particularly, whether financial income from investments in the permanent establishment are always to be treated as foreign source. If the permanent establishment postpones payment of goods and services supplied by the head office and invests the excess cash, the problem arises to whom they belong and which State may tax them. Belgium could defend in a treaty situation that the investment of excess cash is not an activity of the branch so that the country in which the permanent establishment is situated may not tax this income. Double taxation will, on the other hand, occur in a non-treaty situation if both countries want to tax this income.

15. Hinnekens, L., *AFT* November 1984, at 194.
16. See supra, Bours, E. in *Réflexions* at 217 and Siebens, H. in *Réflexions* at 861.
17. Dividends which are exempt from tax because of the affiliation privilege also reduce loss carry-overs, and the computation of the special tax on secret commission fees and the effect hereon of available loss carry-overs led to such unreasonable results that an Administrative Circular had to remedy the situation (Ci. D 191318.113 *BdB* 594 Nos. II/306 and 307 at 655, 688).

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DIVISION OF PROFITS AND LOSSES

The country where the permanent establishment is located will normally treat the establishment as a "separate taxpayer" and accept internal supplies to the establishment at an arm's length price. Normal price means the comparison of the same quantitative relationship in the same market level. Earnings resulting from supplies to the permanent establishment will consequently be composed of two factors:

- For the head office: profit on the sales price to the permanent establishment.
- For the permanent establishment: profit equal to the difference between the sales and the cost price.

The question, however, arises as to whether this result will also be accepted for the head office, especially since there is a "timing" and an "earnings" problem for the head office.

TIMING PROBLEM

No profit is legally nor economically realized by the enterprise when goods are transferred to the permanent establishment. Profits are only made after the sale by the permanent establishment. However, the fact that, for the computation of the profit of the permanent establishment, the "normal price" must be accepted will have as an effect that a non-realized profit will have to be booked, which in turn will have to be eliminated upon consolidation insofar as the goods have not been sold by the establishment at that time.

The problem is slightly more complex in the reverse situation. The permanent establishment supplies goods to the head office at normal prices (i.e. including a profit mark-up). As long as the head office has not sold these goods no profits are realized. The permanent establishment will, however, be taxed on this non-realized profit although this profit cannot be traced in the accounts of the enterprise. It would therefore, from a practical standpoint, be more logical to book the profit as realized from a tax standpoint, but at the same time to book a liability for non-realized profits. Belgian rules provide that non-realized profits on stocks in trade expressed in the accounts, are taxed as stock in trade.[18] The exemption provided in the treaties can then also be claimed so that the operation is tax neutral. However, this solution is not so attractive for profits from a non-treaty country which will pay tax in advance at the rate of 10.75%.

EARNINGS PROBLEM

Does the head office have to follow the earnings splitting as discussed above? Profits of an enterprise are equal to the difference between sales and cost price. If the sale is concluded by the permanent establishment, the question arises whether total profit should not be imputed to the establishment on the basis of the "one legal entity philosophy" which does not permit that a profit is recognized on transactions between head office and permanent establishment.

As it is not for the determination of the profits of the head office that the cost price for the establishment is to be determined on an arm's length basis, problems are encountered by the head office. Economically, earnings could be determined on the basis of value added by the head office and permanent establishment respectively. However, the question arises even then if this approach can be reconciled with the legal and tax concept of profit.

CONCLUSION

From the above discussion of some of the aspects of the relationship between head office and permanent establishment it is clear that there are two important problem areas.

The first source of problems is the determination of world-wide income based on Belgian law if the head office is situated in Belgium. The second source is the qualification of the permanent establishment as a separate taxpayer.

The problems resulting herefrom have not only not been resolved taxwise, but also give rise to various legal and economic problems for which Belgium has not given an adequate solution. The tax administration has not even taken a position on the problem of exchange differences on the closing account between head office and permanent establishment abroad.

International harmonization is therefore even more needed in these areas than in any other.

18. Income Tax Code, Art. 34(1).

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BELGIUM:

Simulation, Fraus Legis and Business Purpose under Belgian Tax Law

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1. GENERAL OVERVIEW

When is the Belgian tax administration entitled to disregard or requalify the transactions of the taxpayer?

A distinction must be drawn between simulation and fraus legis, which can be compared with the "business purpose" under common law.

Simulation

The tax administration may claim that a transaction is a "simulation", i.e. that the parties have disguised the true nature of the transaction under other appearances, which have no basis in reality or in the actual or effective intent. The tax will be levied according to the real facts.

The tax administration does not have, as third parties generally do following Article 1321 of the Civil Code, the choice of relying on the "simulated" or on the real transaction.[1]

Fraus legis

On the other hand, an assertion of "fraus legis" will be made when parties adopt a sincere, although tortuous route and devise their transactions in a way which has no commercial purpose, but rather has the objective of minimizing or avoiding taxation.

Tests of "abuse of forms" or of "substance over form"[2] have been introduced by statute in several countries (e.g. France,[3] Germany,[4] the Netherlands[5]) or developed by the case law, e.g. in the United States[6] and more recently in the United Kingdom.[7] Such general provisions or judicial trends do not exist in Belgium.[8]

The Belgian Supreme Court has held that taxpayers have the right to elect the "least taxed route" even if their transactions are not commercially the most normal, provided that they accept all legal consequences of their transactions and therefore do not enter into a "simulation". In the actual case under consideration, a company had contributed its factory and business to a subsidiary, to which it granted at the same time a sizable loan. Under the law then in force, the interest paid by the subsidiary was deductible and subject only to a formal withholding tax of 11%, whereas, had the same amount been earned by one company and paid out as a dividend, it would have been subject to a 30% withholding tax plus an additional national "crisis" tax.

The tax administration contended that the loan was to be treated as a contribution to capital and the interest as dividends. The Court of Appeals upheld the administration's position, stating at the same time that the loan was a sham although it was not subject to any different secret agreement – thereby contradicting the legal definition of "simulation" – and that it was concluded in fraud of the law, mainly in order to reduce taxable profits.[9]

The Supreme Court reversed[10] the Lower Court decisions not only on the ground of contradiction in motives but also for violation of the legal notion of "simulation" and disregard of the faith and credit due to transactions which are duly evidenced.[11]

1. Louveaux, C.L., *La preuve en matière d'impôts directs,* 1970 at 32. In France the administration has the same choice as any third party.
2. *International Tax Avoidance,* Vol. A, 1979, Part. VII Concepts of international tax avoidance: general, by Wisselink, M.A., at 199-214; Ward, D.A.L., Avery Jones, J.F., Depret, H-R., et al., The business purpose test and abuse of rights, *British Tax Review,* 1985 at 68.
3. Art. L. 64 of the *Livre des procédures fiscales,* formerly Art. 1649 quinquies B of the *Code Général des Impôts.*
4. § 42 Abgabenordnung 1977.
5. Art. 31 *Algemene wet inzake rijksbelastingen* (richtige heffing).
6. Helvering, Gregory V., 293 VS 465 (193 S) embodying the "business purpose" doctrine which pervades the entire Code" (*World Tax Series, Taxation in the United States,* Harvard Law School (1963) at 82).
7. W.T. Ramsay Ltd. v. I.R.C.; Eilbeck v. Rawling (1981) 2 W.L.R. 449; (1981) S.T.C. 174 (H.L.); (1982) A.C. 300; I.R.C. v. Burmah Oil Ltd. (1982) S.T.C., 30 (H.L.); Furniss v. Dawson (1983) B.T.C. 330; (1984) S.T.C. 153.
8. *International Tax Avoidance,* Vol. A, op. cit. at 213, Vol. B, Country Reports, 1978, Belgium, by Wisselink, M.A., at 83.
9. Brussels, 25 March 1959, *Recueil Général (Rec. Gén.),* 1960, No. 20287, 459, *Revue Fiscale (Rev. Fisc.).* 1960 at 213.
10. The word "reversal" is used for lack of a better translation of "casser" and "verbreken". The Supreme Court sets the appeal judgment aside for violation of the law or lack of adequate motivation and remands the case to another court of appeal.
11. Cass. (decision of the Supreme Court), 6 June 1961, Brepols, *Pasinomie* (Pas.), I, 1082, *Rec. Gén.,* 1961, No. 20419, obs. C.S.

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In a subsequent decision, when the Court of Appeals had again disqualified a loan, but failed to expressly requalify it as a contribution to capital, the Supreme Court reversed for violation of the rule of evidence laying the burden of proof on the plaintiff.[12] In order to justify a holding of "simulation", the Court must ascertain the nature of the real transaction laying behind the supposedly "simulated" one.

The same obligation does not rest on the Court when it holds that a transaction – in casu a management contract – is or was totally fictitious and merely sets it aside, reinstating the corresponding payments to profits.[13]

When royalties were paid to a Luxembourg patent holding company whose intervention was deemed fictitious and the royalties were thus considered as being due to and having been received by an individual, the Supreme Court found that "simulation" was validly implied by the holding on fictitiousness, while restating the right of the taxpayer to otherwise act – sincerely – to minimize taxes.[14]

Following the clear statement of the Supreme Court, it is generally admitted that the tax administration will only have the right to disregard a transaction if it is "simulated", i.e. if the apparent transaction differs from the real one, not if, albeit sincere, it is contrived and constructed in such a fashion as to avoid or reduce taxation.[15]

Against the general opinion, Mr. Scailteur, a former Director General of the Belgian Administration of Registration taxes, has for many years advocated the applicability of the doctrine of "fraus legis" (abuse of one' rights) in the tax field.[16]

Belgian Courts have obviously been influenced by traditional French legal thinking, holding that the theory of "fraus legis" cannot be applied in the tax field, because tax law does not nor should compel anyone to place himself in a taxable situation.[17]

Professor Renauld considered that, in view of the technical nature of the tax laws, they could not be used for an unfair or immoral purpose.[18]

More recently, the very use of the concept of "fraus legis" has been criticized by, for instance, Professor Van Ommeslaghe, who considers that the concept should have no place in the domestic field where the prohibition of abuse of law fulfils the same purpose.[19]

Professor Vander Elst disputes the application of "fraus legis" even in private international law, because it endangers the freedom of transactions and of persons. It will be sufficient to prove that the foreign element called upon to apply in a foreign law is "simulated" to bring the situation back within the scope of the proper law.[20]

This interesting discussion, however, is outside the scope of this article, except if Professor Van Ommeslaghe's opinion is accepted, that, but for the elimination of "fraus legis" altogether, it should also apply in the tax field. Abuse of one's right can only be assumed when private interests are prejudiced.

None of these theories, however, could apply in tax matters because Belgian tax law does not in its present state pursue any higher goal than to assess tax according to the wording of the law, whereas, for example, the laws of divorce, competence or inheritance, the laws of corporations or insolvency aim at organizing society along certain definite lines. Perhaps, some day, a preamble may appear to the Belgian tax code stating that it seeks to achieve a redistribution of wealth, and the stimulation of growth or full-employment. Until then, the addition of such general precepts to tax statutes may not be considered as having any legal impact. Thereafter, however, an official goal will substitute the economic freedom of individuals and corporations.

However, some specific provisions of the tax law deny a tax effect to certain non-simulated transactions, but they are few in number. Art. 250 of the Income Tax Code, for example, disregards a transfer of property to a tax haven company for income tax purposes only, except when it is shown that the transaction is legitimate or has been made in return for consideration generating taxable income to the transferor.[21]

Arts. 24 and 46 of the Income Tax Code, on the other hand, though providing for the disallowance of abnormal payments to foreign affiliates or tax-haven beneficiaries are not in the nature of techniques to prevent the attainment of a tax-free result by complicated

12. Cass., 5 September 1961, Gurdal, *Pas.*, 1962, I at 29, obs. W.G., *Rec. Gén.*, 1962, No. 20481 at 138, *Rev. Fisc.*, 1961 at 563.
13. Cass., 14 April 1964, *Pas.*, I, 875, *Rec. Gén.*, 1964, No. 20875 at 342.
14. Cass., 19 October 1965, *Pas.*, 1966, I, 231.
15. Delahaye, A., *Le choix de la voie la moins imposée* (1977) at 131; Coppens, P., et Bailleux, A., *Droit fiscal 1985* at 579; Krings, E. Les lacunes en droit fiscal, in Perelman, *Le problème des lacunes en droit* at 473 ("La théorie de la fraude à la loi . . . consiste à autoriser l'administration et le juge à dépasser les limites de la loi"); de Longueville, J., Simulation et voie juridique la moins onéreuse, *Liber Amicorum, Jean Van Houtte,* T.I. at 315, *Rec. Gén.*, 1975, No. 21937 at 268; Gothot, La fraude fiscale, suppl. to *Rev. Fisc.*, 1962, No. 1-2; Beirens, J., De wetsontduiking in het fiscaal recht vergelijkend benaderd, *Rechtskundig Weekblad (R.W.)* 1974-1975 at 855.
16. Scailteur, C., La fraude légale, *Rec. Gén.* (1955), No. 19535 at 289; La fraude à la loi en droit fiscal, *Rec. Gén.* (1959) No. 20079 at 177; Une conception économique de la fiscalité dans l'application des lois d'impôts, *Revue Générale de Fiscalité (R.G.F.)* (1977) at 163; Fraude et habile application de la loi finale, *Rec. Gén.* (1977) No. 221174 at 353.
17. Vidal, J., *Théorie générale de la fraude en droit français* (1957) at 96-97, 204-207; Perreau, E.H., Des atténuations par actes juridiques aux lois impératives et prohibitives, *Revue trimestrielle de droit civil (Rev. trim. dr. civil)* (1923) at 291, contra: Lerouge, M., Théorie de la fraude en droit fiscal at 115; in Belgium, Matthijs, J., Wetsontduiking, *R.W.* (1955-56) col. 109.
18. Renauld, M. J-G., Considérations sur la théorie de la fraude à la loi étudiée spécialement dans ses applications par la jurisprudence belge, *Annales de droit et sciences politiques (Ann. dr. sc. pol.)*, 1954-1955 at 223 and 229, footnote 9.
19. Abus de droit, fraude aux droits des tiers et fraude à la loi, obs. sub Cass., 10 September 1971, *Revue Critique de Jurisprudence belge (R.C.J.B.)*, (1976) at 337.
20. Vander Elst, J., Arbitrabilité des litiges et fraude à la loi en droit international privé, obs. sub Cass., 28 June 1979, *R.C.J.B.* (1981) at 357 and ref. cited.
21. The tax administration qualifies Art. 250 as a statutory presumption of simulation (Circular of 8 May 1974, *Bulletin des Contributions (B.C.)*, 1974, 1309).

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means.[22] They merely extend the definition of profit (Art. 24) or confirm normal rules governing the determination of profits and the relationship between deductions and the production of income (Art. 46). However, with respect to the determination of the resulting taxable profit, the taxpayer may show that the transaction is genuine.

In this respect it may be observed that the Government itself has recently set a bad example by disguising new tax levies under the name of social security contributions,[23] the only reason being that its programme called for a standstill on tax increases.

Certain judicial decisions have unfortunately obscured the issue by qualifying as simulated transactions which were real, but primarily tax-motivated.

The most striking instances of the application of the theory of "simulation" in Belgian tax cases are the following:[24]

- disregard of corporate form and allocation of profits to an individual:[25] since the law of 6 March 1973, the nullity of a company must be pronounced by a judgment and takes effect "ex nunc". Failing such a decision, a tax assessment may not be based on the simulated nature of the company only.[26] Generally, however, it will be proven that an individual has in fact been the beneficiary of the corporate profits.
- contribution to capital disguised as a loan.[27] Belgian Courts have not yet been confronted, however, with many of the new loan instruments including equity features.[28]
- contribution to capital and loans by a Swiss holding to a Belgian family company were treated as fictitious, with the corresponding amounts being added to reserved profits.[29] This rather striking decision should, if one applies the holding of the Supreme Court in Gurdal, supra, be subject to reversal as the Court should not itself requalify the transaction.
- disguise of an exchange of developed land as an exchange of land and an exchange of buildings, in order to enjoy the reduced rate of registration tax applying to exchanges of land itself.[30]
- in contrast, the Court found no "simulation" where a company purchased property in order to exchange it for another piece of property, instead of letting the seller of the first property purchase the second one: the registration tax on two sales would have been higher than the tax on one sale and one exchange.[31]
- contribution of a building to a company, followed by the sale of shares, in order to avoid the registration tax on the sale of buildings.[32]
- sale of all the shares of a company in lieu of the sale by the company of its assets followed by the distribution of a dividend[33] or of liquidation proceeds.[34]
- purchase by a company of all the shares of a dissolved company, its predecessor in business, in lieu of the distribution of the proceeds of the liquidation of the dissolved company: the liquidation tax

22. Comp. Van Ommeslaghe, P., op. cit. at 348; Examen de jurisprudence (1974-1982) Les obligations, *R.C.J.B.*, 1987 at 131.
23. Royal Decree (R.D.) No. 55 of 16 July 1982, R.D. No. 124 of 30 December 1982, Law of 28 December 1983, Art. 60; P. Glineur, La cotisation spéciale et la cotisation complémentaire de sécurité sociale, Obstacles et stimulants fiscaux et sociaux à l'investissement et à l'emploi, Université Catholique de Louvain (1985) vol. 2, XVIII, 40.
24. See discussion in Delahaye, op. cit. at 93-96 and 140-162; La simulation, *B.C.*, (1925-1975) at 19, Dumon, F., Les impôts directs, l'Etat de droit et la constitution, *Journal de Droit Fiscal (J.D.F.)*, 1984 at 27-28. In other numerous instances, the contention of simulation was rejected. E.g. after several rebuttals, the administration officially gave up the assertion that non taxable "emphyteotic" leases were in fact disguised ordinary leases (Circular of 6 April 1979, *B.C.*, 1979, 729). At the same time, the income from emphyteotic leases was made taxable (Law of 19 July 1979).
25. Mons, 2 March 1977, *B.C.*, (1978) at 89; Mons, 10 May 1978, *B.C.*, (1980) at 235; Liège, 19 May 1982, *Fiscale Jurisprudentie/Jurisprudence Fiscale (F.J.F.)* 82/110, at 190, *B.C.*, 1985, at 1540.
26. Pres. Civ. Brussels, 28 March 1985, *Annales de la faculté de droit, d'économie et de sciences sociales de Liège (Ann. dr. Liège)*, (1986) at 517, obs. Parent, La jurisprudence fiscale et les sociétés fictives depuis la loi du 6 mars 1973. See, on the former situation, Bours, E., *Les sociétés fictives et l'impôt sur le revenu, En hommage à Victor Gothot*, (1962) at 11; Baltus, M., La taxation des gérants non-associés des sociétés de personnes à responsabilité limitée, *J.P.D.F.*, (1964) at 293; Malherbe and Wagemans, Examen de jurisprudence fiscale, 1970-1973, *Droit fiscal des sociétés, R.P.S.* (1974) at 283-285.
27. Cass., 9 March 1965, Ets. Rose-Marie Darquenne, *Pas.*, I at 716, *Rev. Fisc.* (1965) at 366, obs.
28. Faider, Ch., Either a partner or a lender be: emerging tax issues in real estate finance. *The Tax Lawyer*, Vol. 36, (1983) at 191; See on the uncertainty in the definition of loans versus equity contributions, *Transfer pricing and multinational enterprises, Report of the OECD Commitee on Fiscal Affairs* (1979) at 86; Comp. § 385 I.R.C. giving the U.S. Treasury authority to prescribe by regulations whether an interest in a corporation is to be treated as stock or indebtedness.
29. Ghent, 20 June 1986, *B.C.* (1987) at 632.
30. Liège, 14 March 1944, *Rec. Gén.* (1944) No. 18482 at 119, obs. Donnay, *R.C.J.B.* (1948) at 187, obs. Van Houtte.
31. Brussels, 24 December 1910, *Pas.* (1911) II, at 223; Civ. Louvain, 11 February 1911, *Pas.*, III, at 323; contra: Antwerp, 8 November 1907, *Pas.* (1910) III, at 149, recourse rejected by Cass., 30 June 1910, *Pas.*, I, at 380.
32. Civ. Antwerp, 31 July 1902, *Rec. Gén.*, 1902, No. 13681, at 433, confirmed by Brussels, 1 December 1905, *Rec. Gén.*, (1905) No. 14143 at 529; Brussels, 1 March 1939, *J.P.D.F.*, (1940) at 50, obs. Gothot; Civ. Audenarde, 24 October 1961, *Rec. Gén.*, 1962, No. 20463 at 87, obs. Cuvelier, No. 29462 at 81, confirmed by Ghent, 26 March 1965, *R.P.S.* (1965) at 161, obs. Depret; de Longueville, J., L'apport d'un immeuble à une société suivi de la vente par l'apporteur des actions reçues en contrepartie justifie-t-il le fisc à tenir cet apport pour fictif et à exiger le payement du droit d'enregistrement frappant les ventes immobilières, *Rev. fisc* (1968) at 361; Parl. quest. No. 7 of 13 October 1983, Sen. Peeters, *Bulletin Questions et réponses (Bull. Quest. et rép.)*, Sen., sess. 1983-1984, 208, *B.C.* (1984) at 724.
33. Ghent, 26 June 1962, *B.C.* (1963) at 859; Liège, 5 June 1970, Laiterie de la Wiltz, *J.P.D.F.*, (1971) at 182, obs. Baltus, *R.P.S.* (1972) at 200, obs. Malherbe, Le traitement fiscal du changement de tous les associés d'une société, 181-198, *B.C.* (1971) at 1501; comm. Verbeke, La cession des actions d'une société, *R.G.F.* (1973) at 195; Bollen, G., Conséquences fiscales de la cession par des personnes physiques d'une importante participation dans une société, *R.G.F.* (1973) at 75, *B.C.*, at 488, and 1501; recourse rejected by Cass., 28 January 1971, *R.P.S.*, (1972) at 199, *J.P.D.F.* (1971) at 144. The administration has limited the application of this theory to cases where the company modifies fundamentally its activity or where the assignor gives up an activity which is essential to the company: the sale of shares is seen as disguising a sale of the immaterial assets of the company (Circular of 6 December 1972, *B.C.* (1973), at 171). Simulation has not been asserted in the event of sale of shares since 1976, when the capital gain realized on the sale of a 25% holding in a company was made taxable in certain cases (Comp. parl. quest. No. 123 of 24 September 1979, Sen. Coppieters, *Bull. Quest. et rép.*, Sen., sess. 1979-1980 at 89, *B.C.* (1979) at 2150).
34. Ghent, 11 December 1962, Moulins de Wetteren, *Rec. Gén.* (1967) No. 21031 at 188, appeal rejected by Cass., 26 April 1966, *J.P.D.F.* (1966) at 343, obs. Baltus, *Rec. Gén.*, (1967) No. 21031 at 1911 obs. A.C., *B.C.*, (1967), at 1029.

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was levied as if the proceeds had been distributed to the shareholders, whereas a transfer is tantamount to a tax-free quasi-merger.[35]
- capital reduction immediately followed by a capital increase in the amount of the reserved profits, replacing the distribution of a dividend.[36]
- replacement of a dismissal payment by the purchase of worthless shares to the wife of the dismissed manager.[37]

2. APPLICATION TO TAX-MOTIVATED MERGERS AND LOSS CARRY-OVERS

A particularly remarkable development took place in the well-known field of tax-motivated mergers.

In the early years of the application of income taxes, the courts allowed an absorbing company to deduct the losses of the absorbed company provided that the absorbing company carried on the same business ("exploitation") as the absorbed company.[38]

The Supreme Court reversed this rule and set forth the requirement that the losses, in order to be deductible, must have been borne by the same taxpayer as the taxpayer who claims the deduction.[39] This led to the practice of reverse mergers, whereby the loss company absorbs the profitable one. The deductibility in such situations was never questioned until the Court of Appeals of Antwerp was faced with a situation in which the absorbing company had:
- suffered losses amounting to four times its capital;
- suffered a fire destroying its installations;
- dismissed all of its personnel;
- transferred its registered office to the office of the absorbed company; and
- changed its corporate name to adopt the name of the absorbed company.

The Court upheld the decision of the Director of Taxes not to allow the deduction of prior losses on the grounds that the absorbing entity should be considered as being a "dead" company. As a result, the relation between business losses and gains did not even arise any longer and the corporate taxpayer after the merger was not to be deemed as continuing the business of the absorbing company but rather that of the absorbed company.

The conclusion of the Court was that the taxpayer who earned the profits was not the same as that which had borne the losses and was hence not entitled to carry those losses forward ("INES decision").[40]

The Supreme Court upheld the decision, but on a limited basis: it found that the Court of Appeals could validly hold, as it did, in view of the fact that the corporate taxpayer was no longer the same person after the merger and that the losses were no longer deductible according to Art. 114 of the Income Tax Code in view of the facts concerning the carry-forward of previous losses.[41]

This judgment of the Supreme Court cannot be seen as a true application of the theory of "fraus legis".[42]

The decision of the Court of Antwerp has been widely criticized because, as we have seen, Belgian tax law does not admit the theory of "fraus legis" or of a "business purpose".

According to those critics, the Court could find that the corporate taxpayer was "dead" only if it was dissolved according to corporate law and it could not add a condition of economic reality to the statute.[43]

By contrast, in France, it is on the basis of this specific provision disallowing abuse of law and applying "fraus legis" in the tax field that loss carry-overs were disallowed in similar mergers.[44]

However, this type of decision cannot be sanctioned by the Supreme Court because the latter considers it as a factual determination, due care must be exercized not to fall within the scope of this case law on which the tax administration relies extensively.

A recent judgment has followed the "INES reasoning" in similar circumstances.[45]

Some recent decisions shed some light on circumstances under which a company should not be considered as having "changed its tax identity".

A small company held valuable transportation permits. Otherwise it was de facto bankrupt. Its shares

[continued on p. 409]

35. Ghent, 31 January 1975, Maison d'art Dangotte, *R.P.S.*, (1978) at 201, *R.G.F.* (1977) at 179, *B.C.* (1978) at 97, appeal rejected by Cass., 3 June 1976, *R.P.S.*, 209, obs. Dermine, *R.G.F.*, 1977, 186, *B.C.*, 1978, 107; Cougnon, Absorption de société ou liquidation frauduleuse, Réflexions sur les arrêts "Maison d'art Dangotte", *R.G.F.* (1977) at 244.
36. Brussels, 5 December 1972, unpublished, appeal rejected by Cass., 20 December 1973, *J.P.D.F.* (1973) at 343; Brussels, 23 October 1984, *F.J.F.*, 85/44 at 82, obs.
37. Brussels, 26 October 1982, *F.J.F.*, 82/153 at 258, obs. J.C.S., *J.D.F.* (1983) at 311.
38. Brussels, 27 November 1925, *Pas.* (1926) II, at 147; 30 April 1926, *Pas.* (1927), II, at 49.
39. Cass., 8 June 1936, Charbonnages du Hasard, *Pas.*, I, at 282.
40. Antwerp, 2 March 1978, INES, *J.D.F.* (1979) at 344, obs. Malherbe, Ph., *R.P.S.* (1979) at 312, *B.C.* (1981) at 50. Comp. the reasoning of the U.S. Supreme Court in Libson Shops, 353 U.S. 882 (1957); see Sturtevant, P.J., Le sort de la déduction des pertes des années antérieures des sociétés après fusion, en droit fiscal belge et en droit fiscal américain, *J.D.F.* (1985) at 191.
41. Cass., 7 December 1979, *Pas.* (1980) I, at 446, *J.D.F.*, (1980) at 154, *B.C.* (1981) at 56, *R.G.F.* (1980) at 260, étude Tournicourt, R., Déduction des pertes professionnelles après absorption – Considérations à propos de l'arrêt INES, *R.G.F.* (1980) at 254, *R.C.J.B.*, at 184, obs. Dassesse, M., Le report des pertes fiscalement récupérables en cas d'absorption ou de fusion de sociétés: état actuel de la question et incidence sur celle-ci de la troisième directive concernant les fusions des sociétés anonymes:
42. Kirkpatrick, J., Examen de jurisprudence, 1968-1982, Les impôts sur les revenus et les sociétés, *R.C.J.B.* (1984) at 702; Dassesse, op. cit., at 402 contra: Scailteur, C., Le choix de la voie la moins imposée, Réflexions à propos d'un arrêt de cassation récent, in *Réflexions offertes à Paul Sibille*, at 808.
43. Kirkpatrick, J., loc. cit., and Les procédés de récupération des pertes fiscales, in L'entreprise en difficulté, éd. Jeune Barreau Bruxelles, at 253 and 268; Malherbe, Ph. and J., Examen de jurisprudence, *Droit fiscal des sociétés*, 1974-1981, *R.P.S.* (1983) at 146; Vanistendael, F., De werkelijkheid in het belastingrecht, *Liber Amicorum Frédéric Dumon*, at 1066-1071.
44. Cozian, M., Les grands principes de la fiscalité des entreprises (1983) at 33; Gastineau, P., Le régime fiscal des fusions de sociétés et opérations assimilées (1980) at 668.
45. Brussels, 6th chamber, 31 March 1987, *P.C.B.*, unpublished at the time of writing.

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BELGIUM:

International Aspects of Taxation of Executive Remuneration

By Luc Hinnekens

Belgium is anything but a tax friendly country. It is probably the highest tax jurisdiction in the world according to the 1987 Report of the Royal Commission for Tax Harmonization and Simplification. Personal tax rates go up to 67.1%, further increased by surcharges.[1] A general manager earning a gross salary of, say, 4 million Bfrs. will take home only 37% of that amount:

Gross salary	4,000,000 Bfrs.
Social security withholding	(482,800)
Standard business deduction	(125,000)
Taxable income	3,392,000
Personal income tax	1,821,868
Surcharges (8% municipal and 20% ONEM)	224,169
Total tax	2,046,057
Net salary	1,471,943

The gap between gross and the net remuneration has been compared in the case of a general manager of a medium sized company or of a division in a large one. In Belgium he may typically earn a net income (37% of gross remuneration) that is 13% lower than that of his colleague in the Netherlands (42.3%), about 50% lower than that of his colleague in Germany (56.5%) and 200% lower than his equivalent in the United States (74.4%).[2] If tax and social security burden are taken into account, the ratio of the net remuneration to the employer cost at the general management level is fixed at 1 to 4.2 in Belgium (as compared to 1 to 1.8 in Switzerland and France).

The competitive handicap of low net salary and high cost to the employer has caused the Belgian Tax Administration to provide for special tax relief for international employment. It also increasingly induces Belgian executives to look for tax solace in arrangements of split payroll in accordance with a tax treaty or by turning to a more hospitable tax jurisdiction for living and/or working.

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TAX EMIGRATION

Recent studies point to increasing migration of Belgian top executives, caused by the disproportionate gap between employer cost and employee net income. The author of the Wall Street Journal article entitled "The Dismal Picture of Belgian Taxes" concluded: "No wonder that brilliant and ambitious Belgians flee the country as soon as they get a chance to work under less oppressive fiscal systems."[3]

The moving of tax residence or domicile to another country implies the true, complete and permanent relinquishment of the personal and economic attachments to Belgium that are covered by the statutory expression "domicile or seat of wealth" (Art. 3, Code des Impôts sur les revenus, hereafter C.I.R.). The first term of this expression has been interpreted to refer to the habitual abode of the taxpayer and of his family and to the centre of his vital (social, cultural, occupational, etc.) interests. The second term refers to the "seat of his wealth", i.e. the place from where he administers his properties, if such properties are located in several countries. Since the 1965 landmark decision of the Supreme Court in the Derks case, the two terms of the statutory expression is interpreted not to refer to two different aspects of the single concept of tax domicile, but rather to two sufficient and alternative criteria.

1. A first surcharge is levied at a rate up to 10% for municipalities and 1% for agglomerations (e.g. 8 plus 1 equals 9% in Brussels) of the income tax of residents and at the rate of 6% of the tax on non-residents. A second surcharge relates to a contribution to the Office National de l'Emploi/Rijksdienst voor Arbeidsvoorziening (ONEM-RVA) and is levied at the rate of 10% if the taxable income of resident taxpayers exceeds 5,243,000 Bfrs. For taxpayers with a lower taxable income the rate is fixed at 25% of the amount exceeding 3,146,000 Bfrs. The ONEM contribution is prepaid and deducted so that its effective rate is fixed at 1/11th and the transitional rate at 1/5th.
2. "Inter-Europese vergelijking bruto-salaris, netto-salaris, koopkracht, salarisprogressie en kost voor de werkgever voor vier niveau's van kaderfuncties in zes Europese landen en de Verenigde Staten", The Hay Consulting Group, April 1986, Instituut van de Onderneming, Brussel; The Brain Drain. A Belgian problem?, *Weekly Bulletin*, Kredietbank, No. 10, 6 March 1987.
3. Beliën, P., "The Dismal Picture of Belgian Taxes", *Wall Street Journal*, 18 April 1986 at 8.

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The non-resident status of the taxpayer thus requires the location abroad of both his tax domicile *and* of the seat of his wealth.[4]

This ambivalent decision has given rise to dual residence conflicts. They are usually resolved by the preference criteria set forth in the extensive network of Belgian treaties (Art. 4 §2 of the OECD Model Treaties). If the individual thus retains his tax residence in the co-contracting State (e.g. because his seat of wealth is located in Belgium but his permanent home is in the other State), he remains subject to the personal income tax (personenbelasting, impôt des personnes physiques), as distinct from the non-resident tax (niet-verblijfhoudersbelasting, impôts des non-résidents).

Unlike some other countries, Belgium has enacted no anti-avoidance (income or inheritance) tax legislation providing for continued personal tax liability, departure taxes, etc. for emigrating taxpayers.

The relinquishment of the personal attachments implied in the tax residence are often too much of a personal sacrifice to the Belgian executive or to his family. The exercise of his employment in whole or in part abroad will usually not constitute a break in his tax residence. But it may still offer significant opportunities for tax effective compensation packages. The multinational nature of his service and of his employer, the open borders within the EEC and the short distances from and to the home country may lend themselves nicely to foreign or split payroll arrangements.

THE UNILATERAL TAXATION OF RESIDENT EMPLOYEES ABROAD

A Belgian resident is liable for the personal income tax with respect to his world-wide income (Art. 5, C.I.R.). He thus faces double taxation of his foreign source earnings. The Tax Code offers unilateral relief by reducing to one half the personal tax relating to such foreign income (Art. 88, 2°, C.I.R.). The two-fold condition is that the remuneration is earned and taxed abroad.

It is a reasonable interpretation of the first condition that it means that the employment should be exercised abroad; although Art. 88, 2° does not say so and although such interpretation is different from the criterion retained in the same Tax Code for the other purpose of determining whether the remuneration of a non-resident is earned (and therefore taxable) in Belgium (Art. 140 §2, 4°, C.I.R.).

It was suggested by some authors on the strength of some Dutch case law that the statutory term "abroad" is equivocal and that it might not cover the compensation earned by residents on board of foreign ships or aircraft operated in international traffic. But our Administration consistently follows the rule that "ship stands for territory" also in matters of salary taxation.[5]

The interpretation in terms of exercise of activity suggests that the criterion of the presence in the respective countries involved in the employment offers a suitable basis for splitting the remuneration between its domestic and foreign sources. But the text does not dictate a proportionate allocation of the remuneration in all circumstances as it may also reflect different functional responsibilities, cost of living or hardship levels, etc.

The second condition for the unilateral relief relates to the foreign taxation of the remuneration. It is satisfied if the remuneration is subject to foreign tax, irrespective of whether it is effectively taxed or exempted abroad ("Exemption vaut imposition"). But the Administration further rules that the remuneration must be subject to tax in the very country in which it is earned (Com. IR 88/21). This specific source requirement is a restrictive interpretation of the broader statutory expression "taxed abroad".

The tax relief offered by Art. 88, 2°, C.I.R. only alleviates the double taxation. But the net outcome of the remaining double taxation may still be tax attractive. Some Belgian employers have cleverly applied this rule for the benefit of their engineers, technicians, etc. on construction sites or other jobs in African or Arab countries by routing their payroll via an offshore employment company with nominal tax rates such as Cyprus. Assuming a 4% foreign tax withholding and a 70/30 split between Belgian and foreign salary, our manager will thus realize a tax saving in the amount of 278,000 Bfrs., computed as follows:

Gross salary		4,000,000 Bfrs.
Social security withholding		(482,800)
Foreign tax		(48,000)
Standard business deduction		(125,000)
Taxable income		3,344,000
Personal income tax		1,788,808
Less 50% of portion relating to foreign taxable income computed as follows		(259,650)
– Foreign salary		1,200,000
– Social security deduction		(144,840)
– Foreign tax		(48,000)
– Standard deduction		(36,289)
– Tax allocable thereto	1,788,000 ×	970,871 / 3,344,000
Personal income tax		1,529,098
Surcharges		191,165
Total Belgian tax		1,720,263

4. Cass., 7 September 1965, Derks, *Recueil Général* No. 20972, 360; Cass., 28 October 1982, *Fiscale Jurisprudentie/ Jurisprudence Fiscale (FJF)* 83/189; Hinnekens, L., "L'habitant du Royaume dans le droit fiscal contemporain", *Revue Générale Fiscale,* 81.8-9, 163; Hinnekens, L., "La qualité de (non-)résident: une détermination complexe", *Revue Générale Fiscale,* 85.8-9, at 155.

5. *Fiskoloog Internationaal*, 84.06.043 referring to a 22 February 1983 decision of the Court of The Hague; Com. I.R. 88/20; Hinnekens, L., De territorialiteit van de Belgische belastingen in het algemeen en op de inkomsten in het bijzonder, Samsoms Fiscale Monografieën, CED-Samsom, 1985, at 51.

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THE ABOS-CIRCULAR

Our Administration has further improved on those rules by setting up a special tax system available to Belgian engineers, technicians, etc., assigned to a non-European non-tax treaty country (the ABOS or AGCD-Circular).[6] Aside from the possibility of claiming non-resident status if the duration of their assignment is at least 18 months, they may claim an extra standard deduction of 30% up to 450,000 Bfrs., the exclusion of their allowances for housing, schooling, medical care, cost of living differentials, etc. Setting aside even the latter exclusion and the rule that a portion (normally 30%) of the remuneration may be deemed taxed abroad for purposes of the 50% tax reduction, our manager would thus realize a tax saving in the amount of 958,000 Bfrs. if his 4,000,000 Bfrs. salary is earned and taxed at, say, 4% in a non-European non-treaty country:

Gross salary	4,000,000 Bfrs.
Social security withholding	(482,800)
Foreign tax	(160,000)
Standard business deduction	(125,000)
Extra ABOS deduction	(450,000)
Taxable income	3,265,000
Personal income tax	1,734,100
50% tax reduction	(867,050)
Surcharges	148,186
Total tax	1,015,236

The extra deduction is even raised to 50% with no ceiling in the optional "colonial regime", available to Belgian employees working in Zaire, Rwanda or Burundi.[7]

The ABOS and the colonial special tax regimes continue to be applied by the Administration, notwithstanding the fact that the Court of Appeal of Liège concluded in 1982 that the ABOS-extra deduction finds no basis in the tax statute. And the possibility of finding an alternative legal basis for the extra-deduction by treating them in the same manner as in the redraft of the Circular for expatriates (i.e. as business expenses pertaining to the employer rather than to the employee) is not available as the reimbursement of such employer expenses are already now excluded in the ABOS-Circular.[8]

THE TREATY TAXATION OF BELGIAN RESIDENTS ABROAD

The aforementioned rules of Belgian tax law and administrative practice do not apply where a tax treaty applies. The latter situation is not uncommon as Belgium concluded more than 40 tax treaties covering most of its trade partner States.

The allocation of the power to tax remunerations between the country of residence and that of exercise of the employment depends on the nature of the employment (directors, artists and athletes, students, etc.), of the employer (Government or private), of the income (pension or current salary) and of the special circumstances under which their employment is exercised (on board of ships, aircraft, in the border area, etc.). We will only consider the case of current remuneration, derived by a regular employee from his performance of private service in ordinary circumstances.[9]

The applicable rule is found in the equivalent of Art. 15 of the OECD Model Treaties. It provides that:

(1) The remuneration is taxable only in the State of the residence of the employee; (first part of first sentence of Art. 15(1)).

(2) Unless (exception) the employment is exercised in the other contracting State (source or work State): in such case it may be taxed in such other State (second sentence of Art. 15(1)). Belgium as the residence State grants an exemption, subject to the so-called progression reservation (Art. 23B). The latter reservation is not significant for top salaries as the maximum marginal rate of the personal income tax is reached at 4,080,000 Bfrs. (71.6%) and gradually drops thereafter (to 67.1% as of 14,516,178 Bfrs.)

(3) Unless (exception to exception) the employment in such other State is exercised under the three conditions of Art. 15(2): in such case the sole right of the State of residence (Belgium) is reinstated.

While the normal jurisdiction is that of the State of residence (first and third rule), the increasing interest of the employee, if he is a Belgian resident, goes to the maximum application of the source country tax rule. This is so because the nominal tax rates and even the deductions tend to be more favourable in other tax jurisdictions and because the income split causes a significant cut in the tax progression if tax rates are applied starting again at the bottom of the rate scale in the source country or countries.

If in our example the salary of the general manager is split 70/30 over his service respectively in Belgium and in Germany, his tax saving is 384,000 Bfrs., computed as follows:

Gross salary	4,000,000 Bfrs.
Social security withholding	(482,800)
German tax on 1,200,000 Bfrs. (Assume 1 DM = 20 Bfrs.)	(332,535)
Standard business deduction	(125,000)
Taxable income	3,059,665
Personal income tax	1,592,419
Less tax allocable to foreign taxable income computed as follows	(361,333)

[Example continued on next page]

6. Ci. RH 241/256.219 of 8 February 1979 as amended; Com. I.R. 51/22 and 88/24.
7. Com. I.R. 51/23 and 139/4.
8. Court of Appeals, Liège, 20 January and 30 June 1982, Wangneur, Algemeen Fiscaal Tijdschrift, 1984-5, at 126-127 with note L. Hinnekens; *Fiskoloog Internationaal*, 15 June 1984, at 4.
9. A more complete case study is found in Hinnekens, L., "Het fiscaal statuut van Belgen tewerkgesteld in het buitenland en van buitenlanders tewerkgesteld in België", Actuele Problemen van het Arbeidsrecht 2, Kluwer rechtswetenschappen, Antwerpen, 1987, at 135-172.

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– Foreign salary		1,200,000
– Social security deduction		(144,840)
– German tax		(332,535)
– Standard deduction		(28,362)
– Taxable income		694,263
– Tax allocable thereto	1,592,419 ×	694,263 / 3,059,665
Personal income tax		1,231,086
Surcharges		98,487
Total Belgian tax		1,329,573

The tax saving is even more significant if a lower tax jurisdiction is involved and if an even lesser portion of the remuneration is allocated to Belgium. It thus amounts to 451,341 Bfrs. and 597,413 Bfrs., respectively in case of a 70/30 and 30/70 income split between Belgium and France.

Under Art. 15, our manager must fulfil two conditions: the burden of proof being on him with respect to the first one and on the Belgian Administration with respect to the second one.

Firstly, the employment must in reality be exercised in the other contracting State. We have no knowledge of any case law or administrative regulations or rulings offering specific guidelines as to the allocation method. A split according to the time that can reasonably be expected to be spent on business in the one and the other country is generally deemed safe vis-à-vis the two (or more) Administrations concerned. But other serious criteria such as different functional responsibilities may justify a non-proportionate allocation of the total remuneration in the employment contract(s).

THE 183-DAY TREATY RULE

A second restriction is found in the application of the (third) domicile jurisdictional rule, set forth in the treaty provision corresponding to Article 15(2) of the OECD Model Treaties. Although this rule "is intended to facilitate the international movement of qualified personnel",[10] the tax effective compensation packages and payroll arrangements between Belgian residents and their employers are usually designed to prevent its application. This is accomplished by not fulfilling at least one of its three conditions, reading as follows:

(a) The employee is present in the source State for a period or periods not exceeding in the aggregate 183 days in the fiscal year concerned (Art. 15(2)(a)).

Other treaties refer to the "calender year concerned". The two expressions coincide in Belgium and in most contracting States. A special Circular of 4 July 1986 deals with the complication of the U.K. fiscal year (from 6 April to 5 April of the year thereafter). A Belgian resident employed in the U.K. from, say, 1 November 1986 through 30 September 1987 is taxable only in Belgium in 1986, but also in 1987. Only some treaties (Sri Lanka, Indonesia and Malaysia) exceptionally refer to "any uninterrupted period of 12 months".

Some treaties expressly stipulate that weekends, legal holidays and normal holidays are added to the days spent in the source country. According to the Belgian Administration, the same rule applies as a clarification to all other treaties. Its further explanation that such days "need not be deducted" where the applicable treaty refers to "presence in the other State" (whereas they "must be included" where the treaty refers to "exercise of activities in the other State") may probably be ignored as sloppy language (Com. Conv. 15/15). The regulations offer no guidance with respect to incomplete days or days of business travelling in third countries or of travelling to and from home. According to the French interpretation of the French–Belgian treaty, such days are likewise included, assuming the temporary employment in the other State is not ended by such interruptions.[11]

(b) The remuneration is paid by, or on behalf of, an employer who is not a resident of the other State (Art. 15(2)(b)); i.e. who is a resident of the State of residence of the employee or of any third country.

But some treaties do not allow for the latter possibility: the employer must reside in the State of residence of the employee (France, Singapore, Thailand) or must at least maintain a permanent establishment therein (United States). Such formulation confers expanded powers of taxation to the source country.

The French and Dutch texts of most treaties use the expression "paid by or in the name of" (payées par un employeur ou au nom d'un employeur/betaald door of namens een werkgever). They should be read to mean "paid by or on behalf of"/"pour le compte de", i.e. "for the account of", in accordance with the official English and French texts of the OECD Model 1977 and probably also with the meaning that "the remuneration must be borne by" (sa rémunération est supportée par) in the sense in which such expression is used in the formulation of this condition in the treaty with France.

The Administration applies the test of the charge back of the payroll cost to support its source State claim to tax the salary paid by a foreign employer who temporarily sends his employee to an employer in Belgium and who charges back the payroll cost to the latter employer (Com. Conv. 15/16). But in recent tax complaint procedures it has ruled that it remains also empowered to tax the salary in the reverse situation of an employee whose normal Belgian employer continues to make the payment, irrespective of the fact that the cost thereof is charged back to the foreign employer to whom he is being assigned. The Administration appears to rely on its broad interpretation of the parallel expression in the domestic legislation (Art. 140 §2, 4° C.I.R.: "à charge de") and/or on the textual argument that the treaty expression "paid by, or on behalf

10. Art. 15 Comm. Report of the OECD Committee on Fiscal Affairs, 1977, at 131.
11. Commentaires Convention du 10 mars 1964 modifiée, Doc. Part. Imp. Dir., Francis Lefebvre, at 303.

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of, an employer" (and specifically the meaning of the word "or") supports the conclusion that this condition for residence State jurisdiction is also fulfilled by the sole fact that the remuneration is being paid by an employer who is not a resident of the source country.

This double catch interpretation (each term of the expression being treated as a separate and sufficient criterion) is not very plausible in a provision that is designed to avoid double taxation. Such provision can be better interpreted by analogy with the third condition ("not borne by a permanent establishment") as it serves the same purpose of conferring the right of personal taxation to the State of the enterprise whose taxable profits are effectively reduced by the payroll cost being charged back.[12] A better application of the treaty rule in situations where employees are, according to civil law, employed by two employers, is to retain solely the employer who is ultimately liable for the payroll cost. The condition according to the ambivalent expression "paid by or on behalf of" should thus read: if the remuneration is paid by an employer who is a non-resident when he also bears the cost thereof or if it is paid for the account of such employer in situations where the payment and the ultimate liability do not coincide.

But as long as the Courts have not overruled the interpretation of the Belgian Administration (and of those foreign administrations that espouse a similar double catch interpretation), a safe haven practice is to avoid the risk of the second situation by a payroll arrangement in which the salary is both paid and borne directly by the employer in the foreign country in which the Belgian employee is temporarily detached.

The case law is surprisingly rare for an issue that has become very common in the international employment and payroll practice. The Court of Appeals of Mons reviewed on 8 March 1984 the case of artists residing in France and participating in an event organized in Belgium by a Belgian non-profit organization. Their remuneration was held to be taxable solely in France as only the French company acted as their employer and the Belgian non-profit organization submitted no evidence that it had borne the remuneration.[13] In the treaty with France, artists with employment status are covered by the general provision concerning dependent personal services, but the wording of this condition in the general provision of this treaty is special ("rémunération supportée par").

A similar conclusion was reached under the general wording of the treaty between Belgium and the Netherlands by the Amsterdam Court on 19 April 1983 in a case involving a Dutch resident employed by a Dutch company in the Netherlands and by a related company in Belgium. The remuneration paid by the Dutch company with respect to the activity in Belgium (less than 183 days) is subject to Dutch taxation if no evidence is submitted to the effect that it has been charged back to the Belgian employer.[14]

While our Courts do not readily lend an ear to foreign case law, the reading by the other contracting State of a treaty expression requiring a common interpretation should in principle have the same interpretative value as that of a Belgian Court decision. Belgian authors have also given attention to the 13 October 1962 decision of the München Finanzgericht and even more to the 21 August 1985 decision of the Bundesfinanzhof.[15] While their interpretative value is less in Belgium as they involve treaties to which Belgium is not a contracting party, they offer a more explicit clarification and interesting explanation of the same expression borrowed from the common OECD Model Treaties. The remuneration is exempt in the country of residence (Germany) if it is paid by a German employer to a German resident detached during 147 days with a Spanish affiliate company, because it must be deemed paid on behalf of the Spanish employer when it decreases the profit taxable in Spain pursuant to a corresponding charge back by the German company of the payroll cost and when the Spanish company effectively acts as an employer vis-à-vis the detached employee.

The Dutch and German decisions appear to be contradictory with respect to the clarification whether the charge back of the payroll cost must be specific or may also be accomplished by means of its inclusion into the pricing of the goods or services sold to the Belgian or Spanish company. While we know of no Belgian ruling or case law on this issue, we note that only the requirements of "an employer" and "remuneration paid by or on behalf of" are essential for the condition according to its treaty wording. The method of the charge back, like the terms of the employment contract, are only relevant for purposes of proving the satisfaction of those requirements.

(c) The remuneration is not borne by a permanent establishment or a fixed base which the employer has in the other (source) State. (Article 15(2)(c)).

The text of this condition as well as its interpretation by the Belgian Tax Administration is less equivocal than that of the second condition.

The clarification that the remuneration may not be borne "directly" or "as such" is added to the text in several treaties and is assumed to apply likewise in the other treaties. It is applied in the Administrative Regulations to the effect that the remuneration is not so borne when the salaries pertain to the general and administrative personnel of the non-resident enterprise and as such are included in the general and administrative cost or the price of the goods and services allocable to the permanent establishment (Com. Conv. 15/17, in fine).

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12. Hinnekens, L., "De 183-dagenregeling", *Tijdschrift voor Fiscaal Recht*, No. 70, 1987, at 131-144; *Fiskoloog Internationaal*, 85.02.093, 85.05.117 and 86.10.229.
13. Court of Appeals, Mons, 8 March 1984, *FJF* No. 85/3.
14. Hof van Amsterdam, April 1983; Viersen, A.D.J., "Door of namens", *Maandblad voor Belastingbeschouwingen (MBB)* No. 12, December 1984, at 1393; Kooi, J., "Wederom door of namens", *MBB*, No. 11, November 1985, at 283.
15. Bundesfinanzhof, 21 August 1985, *Bundessteuerblatt*, 1986, Teil II, at 4.

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THE TREATY TAXATION OF NON-RESIDENT EMPLOYEES IN BELGIUM

Our discussion can be shorter when we turn to the reverse situation of the non-resident employee working temporarily in Belgium. The situation is usually governed by a treaty and specifically by the provision corresponding to the aforementioned Art. 15 of the OECD Model Treaties. It should obviously be interpreted by the Belgian Administration according to the same criteria that it applies to support the right of Belgium as State of residence to tax the salary of Belgian employees working abroad.

In particular we pointed out the inconsistency of the administrative interpretation of the (second) condition of Art. 15(2)(b) to the effect of supporting the Belgian right to tax salaries "paid by" a Belgian employer to a resident employee temporarily detached to a foreign employer, even if the latter bears the cost thereof. By applying the sole test of the employer bearing the payroll cost, we conclude that Belgium as the source country has no power to tax the salary of the foreign employees assigned to Belgium for less than 183 days per year. Foreign employees usually reside in a lower tax jurisdiction than Belgium and may therefore have a greater interest in satisfying the conditions of the 183-day rule than Belgian residents being assigned abroad.

With respect to the other condition that the remuneration may not be borne by a permanent establishment in Belgium (Art. 15(2)(c)) lest it become subject to Belgian tax, the treaty definition of permanent establishment excludes all situations in which the foreign employer maintains a Belgian establishment that satisfies the establishment test of Art. 140 §3 of the Tax Code, but not that of the treaty. This may be the case because it constitutes a negative case of permanent establishment according to Article 5(4) OECD Model 1977 (certain coordination and other preparatory and auxiliary activities) or because it does not satisfy the minimum duration in Article 5(3) in regard to construction sites.

The criterion "who bears the payroll cost" for the application of Art. 15(2)(b) and (c) offers some flexibility to the parties to the employment contract(s) for avoiding Belgian taxation by leaving the final liability with the foreign employer or head office. But the Administration relies on the arm's length dealing rule of Arts. 7 and 9 of the OECD Model Treaties to reinstate the Belgian right to tax whenever the accounts are rewritten because the services of the detached employee were rendered for the benefit of the Belgian company or permanent establishment (Com. Conv., 15/17).

UNILATERAL TAXATION OF FOREIGN EMPLOYEES IN BELGIUM

As a tax treaty can itself create no tax liability or in situations not covered by any treaty, it is important to first determine whether the remuneration of non-resident executives is taxable in Belgium under domestic source rules.

According to Art. 140 §2, 4°, C.I.R.,[16] the salary is earned in Belgium if it is borne (ten laste van/à charge de) by a Belgian resident or Belgian establishment of a foreign company. The connecting factor is therefore not the place of the exercise of the employment (lex loci laboris); although the remuneration so earned and taxable in principle becomes exempt pursuant to another rule in so far as it relates to services rendered abroad (Art. 141, 2°, C.I.R.).

Taxation abhors a vacuum. But the choice of statutory criterion implies the risk of a gap between the (second) treaty rule of source State jurisdiction and this domestic tax rule, whenever the foreign employer continues to pay the salary of its executive detached in Belgium without charging back the cost thereof to its Belgian affiliate or branch (coordination center, etc.). The Administration may try to close the gap by proving the resident status of the employee or by finding a permanent establishment of the foreign enterprise.

A controversy relates to the correct interpretation of the test of Art. 140 §2, 4° ("remuneration borne by") parallel to the conditions of Article 15(2)(b) and (c) of the treaties ("remuneration paid by, or on behalf of" or "borne by") determining domicile versus source State taxation according to tax treaty. It has thus been argued that the remuneration paid to a non-resident employee working in Belgium is not taxable if it is paid by a Belgian employer, but borne by a foreign employer, e.g. in the case of detachment to Belgium. In principle an expression of domestic tax law is interpreted independent from the (international) meaning of a treaty expression. The use of the words is not completely identical at least in the French text of the treaty provision (supportée par) and in the domestic rule (à charge de). Specifically, the term "remuneration borne by" (à charge de) in Art. 140 §2, 4° of the Tax Code appears to be broad enough to include the salary paid by a Belgian employer, irrespective of whether its cost is charged out to a foreign employer and irrespective of the more restrictive meaning of the treaty expression. This double catch interpretation ("either paid or otherwise borne by") of the domestic connecting criterion is likely to give rise to double taxation but that concern is no legal impediment in non-treaty situations.

THE TAX CIRCULAR FOR EXPATRIATES

The application of the tax rules for non-residents to foreign nationals temporarily assigned to foreign controlled companies or branches in Belgium is the subject matter of the Circular of 8 August 1983.[17]

16. Art. 140 §2, 4° provides, among others, that salaries paid to non-resident individuals to the account of individuals, companies or other entities resident in Belgium or of establishments in Belgium of non-resident individuals, companies or entities are subject to Belgium income tax.
17. Com. I.R. 139/6 through /9 and 142/2 through /5.1. A discussion of the Circular is found in Vanheeswijck, L., "De belasting van buitenlandse kaderleden in België", *Fiscale praktijkstudie* 4, Kluwer rechtswetenschappen, Antwerpen, 1987.

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Its tax benefits relate mainly to the non-resident status of such executives, the exemption of their remuneration with respect to the days spent abroad, and the exclusion of their allowances relating to home leave, tax equalization, cost of living and housing differentials, etc. up to a maximum amount of 1,200,000 Bfrs. for coordination and research centres and of 450,000 Bfrs. for other companies (plus school fees and moving expenses).

If the general manager in our previous example would be a foreign national temporarily working in Belgium for a Belgian subsidiary or branch of a foreign enterprise, travelling abroad to the extent of 50% of his working time and earning a gross salary of 4,000,000 Bfrs. (including the reimbursement of cost of living differential, tax equalization, etc. up to 450,000 Bfrs.), his personal tax liability would amount to only 624,207 Bfrs., computed as follows:

Gross salary	4,000,000 Bfrs.
Social security withholding	(482,800)
Expenses for account of the employer	(450,000)
	3,067,200
Exempt foreign income (50%)	1,533,600
Standard business expense deduction	(106,680)
Taxable income	1,426,920
Non-resident tax (including 6% surcharge)	624,207

The 1983 Circular is a redraft of the earlier Circular which had been criticized by the Courts. In some cases the non-resident status had been disallowed, although such disallowance related less to the definition in the Circular than to its application in extreme cases.[18] More often the Courts of Appeals and the Supreme Court had raised ex officio the lack of legal basis for the extra deduction (30% up to 450,000 Bfrs.) granted by the old Circular on the score of the extra expenses typically incurred by expatriate employees.[19] The extra deduction of such expenses has therefore been replaced in the new Circular by their exclusion from the taxable income of the executive as the reimbursement of expenses pertaining to the employer.

CONCLUSION

We started our review of the Belgian income tax implications of international employment and compensation packages by pointing out the disproportionate burden of Belgian personal taxation. The 1987 Report of the Royal Commission for Tax Harmonization and Simplification outlined the guidelines for a tax reform including the recommendation that the number of the marginal rates of the personal income tax should be reduced to four and the maximum effective tax to 50%. The Minister of Finance has promised a Tax Reform Bill, it is uncertain to what extent it will be borrowed from the recommendations of the Royal Commission.

In the meantime the exercise of the employment in one or more other countries and an appropriate payroll arrangement may offer to Belgian executives working abroad significant tax relief under the conditions set forth in the domestic tax legislation or in the applicable treaty provision. Belgian executives working in non-European non-treaty countries as well as foreign executives temporarily detached in Belgium are also eligible for the personal tax benefits promised by Circulars. But while there can be no doubt about the economic justification of such administrative regimes, there is some concern that the Courts may deem them to be "praeter or contra legem" and therefore violative of the requirement in Art. 112 §2 of the Constitution that no tax relief may be granted other than by law.[20]

18. Court of Appeals, Antwerp, 5 March 1984, Van Braak, Algemeen Fiscaal Tijdschrift, No. 4, 1984; Hinnekens, L., "Hoe wettelijk en essentieel is de hoedanigheid van niet-verblijfhouder in de Circulaire voor buitenlandse kaderleden?", *Liber Amicorum A. Tiberghien*, Ced-Samsom/Kluwer, 1984, at 217.
19. Mainly Cass., 19 November 1981, De Monts, *FJF*, 82/12; and Cass., 21 May 1981, *FJF*, 82/159.
20. Hinnekens, L., "La valeur juridique de la Circulaire fiscale: Quo vadimus?", *Revue Générale Fiscale*, 84.11. at 194.

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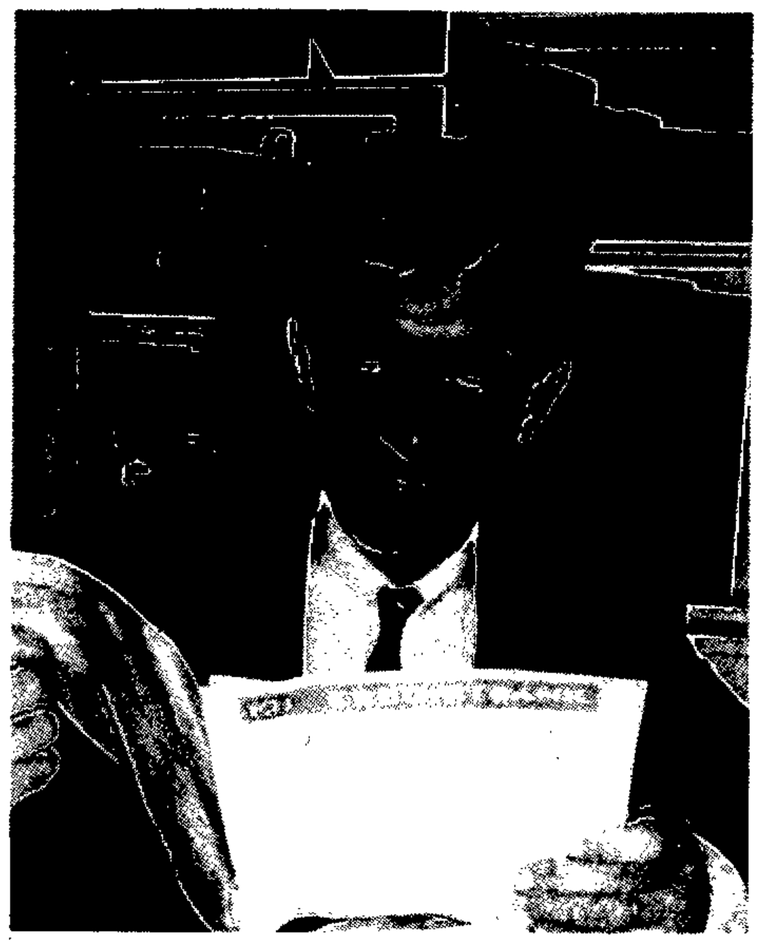
BELGIUM:

Tax Incentives for Scientific Research Activities

By J. Autenne

Being aware of the importance of research for Belgium's industrial and service activities, Belgium has enacted specific tax incentives, in addition to the grants already offered by the national and regional authorities. These measures are formulated to make sure that the work of our highly qualified scientists could be transformed into marketable products or services.

The purpose of this paper is to give a brief survey of some of those specific tax incentives, taking into account that an investor will have to choose between putting research activities within an existing legal entity or setting up a new company.



Jacques Autenne received his Doctorate in Law in 1967 from the Catholic University of Louvain. He has served as Secretary for the Belgian-Luxembourg section of IFA and presently acts as Director of the Department for Economic and Fiscal Affairs of the Federation of Chemical Industries of Belgium as well as being a lecturer at the Catholic University of Louvain.

Accelerated depreciation of R & D assets in 4 years

Rate of interest taken into account for present value computation	Investment deduction	Depreciation 1st year	2nd year	3rd year
8%	25%	50	25	25
Present value			23.15	21.43=119.58

A. RESEARCH ACTIVITIES WITHIN AN EXISTING COMPANY

I. Investment deduction

For investments in scientific research or the development of new products and emerging technologies, taxpayers may claim, above the normal depreciation, an investment deduction from their taxable profits amounting to 25% of its cost.

The deduction applies only to investments that are depreciable in at least 3 years. The Belgian legislation, with respect to the annual accounts, leaves the taxpayer to choose between a deduction of the full R & D costs in the year they occur or to have them considered as an asset and depreciated in less than 5 years.

If we take into consideration that to benefit from the investment deduction it is necessary to treat R & D as an asset in the annual accounts, the net financial advantage resulting from this incentive as is shown on the table above is not 25% of its cost, but 19.58 × 43% (Belgian corporation tax rate) = 8.42%.

The deduction applies to the value of the R & D costs (salaries of researchers and research material) as well as the acquisition cost of patents, know-how, and licences for so far they are not yet exploited in Belgium.

Unless the R & D takes place in a research unit of the company, in order to have the benefit of the deduction the conditions specified in the Royal Decree of 23 December 1982[1] must be fulfilled.

Proof of the existence of a research unit must be contained in specific accounts giving the detailed costs of the R & D activities.

II. Accelerated depreciation

As shown in the table above, companies may elect to depreciate their assets partially or wholly on the basis of the declining balance method at a rate which is twice that of the straight-line method on the remaining value.

With regard to plant and machinery used for scientific research, the tax authorities will allow them to be depreciated using the straight-line method over a 3-year period (33⅓% per year) even if the useful lifetime of the asset is longer.

III. Deduction for additional researchers

Taxpayers may deduct from their taxable profit 100,000 Bfrs. any year they employ an additional researcher.

1. Official Gazette of 31 December 1982.

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This deduction can be added to the deduction of 150,000 Bfrs. for any additional worker employed in companies of less than 50 workers or of 120,000 Bfrs. in companies of less than 100 workers.

B. SCIENTIFIC RESEARCH WITHIN A NEW COMPANY

Next to the three measures set forth above, the creation of a new company to lodge research activities and the marketing of its results or of the new products or services this research could generate, gives a right to the following tax incentives.

1. T-zones[2]

Any new company having all its establishments in one of the 7 Belgian T-zones is exempted from corporate taxation during 10 years provided this company is incorporated under Belgian law; performing research activities regarding highly technological products; or belongs to one of the following sectors:

- advanced data processing;
- software technology;
- micro electronics;
- office technology;
- robotics;
- telecommunication; or
- bio-engineering.

Dividends and interest paid out by these companies are also granted a fictitious withholding tax credit of 25/75 within certain limits.

However, on request of the EEC authorities, the financial grants from the national or regional authorities are not allowed to exceed the tax incentives attributed to those companies established in T-zones.

2. Coordination Centers

The profits of a Coordination Center are taxed on a lump-sum basis (cost plus basis after deduction of the salaries and financing costs).

Moreover, dividends and interest paid out by Coordination Centers are granted a fictitious withholding tax credit of 25/75 within certain limits.

Scientific research as well as the collection and supply of information are typical activities that can be lodged in a Coordination Center (next to centralization of financial transactions, insurance and re-insurance, centralization of accounting, administrative or information technology services, . . .).

A Coordination Center can only be formed by an international group of companies with a consolidated capital of at least 1 billion Bfrs. and a consolidated turnover of at least 10 billion Bfrs. Furthermore, it has to be staffed by at least two full-time employees within 2 years from the date on which the center's activities start.

The Coordination Center which qualifies has to be approved by Royal Decree in order to benefit from the tax incentives.

3. Innovation companies

A new company created between 1984-1993 can be recognized by the Minister of Finance as an "innovation company" when its business activity exclusively consists of supplying services or manufacturing products using high technology processes.

This process must be used by no other Belgian corporation at the time of application for recognition.

The company may be established anywhere in Belgium. However, as this measure is especially intended for smaller enterprises it will not be authorized to employ more than 99 employees during the period it benefits from the specific tax incentives.

The main tax incentives, next to financial grants, are:

- exemption for 10 successive financial years from corporation tax for its distributed profit to the extent of 13% of the paid-in capital; however, during the first 3 years this exemption applies as well to the retained profit as to the distributed profit; the last moment when this 10-year exemption period may start is, at the election of the company, the third year of its existence;
- the investment deductions of 25% for R & D activities, 20% for energy saving investments, and 11% for all other type of investment which fulfill the legal requirements are increased to, respectively, 30%, 25% and 16%;
- capital gains realized by share corporations in innovation companies are exempted from income tax provided these shares were subscribed to by the seller;
- private persons who subscribed shares in innovation companies can deduct half of its price from their taxable income unless these persons are employed by the innovation company in which case they can deduct the entire subscription price (the deduction is spread out in both cases over a 5-year period).

4. "Reconversion" companies

There are two types of "reconversion" companies, those which enter into a "reconversion" contract with a public investment company and those new companies locating all their activities in a "reconversion" zone.

These companies must contribute to the modernization of the industrial activity of the "reconversion" zones. Zones recognized by the EEC as having a right to regional grants qualify.

2. T-zones are tax or duty-free employment zones which have as a primary purpose the providing of employment opportunities in Belgium.

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The second type of "reconversion" companies benefit from an exemption of corporate tax for the distributed profits of the company up to an amount of 13% of the paid-in capital in so far as it is invested in new and tangible assets.

Like the innovation companies, this exemption stretches over a period of 10 years starting, at the election of the company, the first, second or third year after incorporation.

CONCLUSION

The purpose of this paper was not to give a detailed analysis of the Belgian tax incentives in the field of research, but to briefly summarize them.

It is clear that an optimalization of these incentives combined with the financial grants needs a thorough analysis of the company's business plan.

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- "Incitants fiscaux aux entreprises informatiques implantées en Belgique" in *Droit de l'Informatique* by J. de Lame.

[continued from p. 399]

were sold and a company controlled by the purchasing group contributed to the company the valuable transportation branch of its activity. The Court held that the recapitalized company was not dead and that as it could be revitalized by a contribution of management and capital and it did not lose its identity by the recapitalization.

On the contrary it was found to have safeguarded its transportation permits and maintained its activity for the benefit of its new shareholders.[46]

In other cases, the administration disputed the tax-free status of mergers which had in its opinion no business justification. The Courts consistently held that, except in the case of "simulation", the conditions provided by law for the tax-exempt merger status were met and that the law did not call for the additional condition that the merger be commercially justified. These decisions are obviously difficult to reconcile with the holding of the Court in INES.[47]

3. SALE AND LEASE-BACK

More recently, the Supreme Court found for the taxpayer in a classic sale and lease-back situation. A shipping company had transferred two ships to a subsidiary which immediately rented them to the operating shipping parent. The long-term capital gain of the seller was taxable at a reduced rate, whereas the purchaser could resume depreciation of the otherwise fully-depreciated assets and deduct it against income taxable at the normal rate of tax, enjoying moreover a special deduction for having made an additional investment.

The Court of Appeals allowed the deductions, finding that the transactions, although tax-motivated, were not "simulated".[48]

The Supreme Court considered that no laws had been violated when the judge in appeal had found that the purchases were real and that the ships were used in the business activity of the purchaser.[49] Interestingly, the Court did not even rule on the violation of an alleged tax principle of economic reality.

CONCLUSION

Modern social organization has shown an extreme restraint towards judges by elaborating a detailed set of statutory rules to be applied by them in the exercice of their function. Reasonings whereby judges substitute their vision of economic reality to the legal situation created by parties, in the absence of "simulation", open the door to errors and arbitrariness and create insecurity. If it is to be provided that transactions must conform to certain economic patterns to be acceptable taxwise – only statute can do so.

46. Brussels, 3 April 1984, *J.D.F.*, (1985) at 269, *Algemeen Fiscaal Tijdschrift (A.F.T.)*, (1984) at 160.
47. Ghent, second decision in the Firestone matter, *J.D.F.*, (1981) at 269, *B.C.* (1981) at 2428; Ghent, 11 January 1985, *J.D.F.* at 273, Annales de Droit de Liège, 1986, 479, obs. Malherbe, Les fusions de sociétés immobilières.
48. Antwerp, 4 December 1984, *F.J.F.* 85/66 at 121, obs. A law of 4 August 1986 has specifically made sale and lease-back inoperative taxwise.
49. Cass., 27 February 1987, unpublished at the time of writing, comm. in *Courrier fiscal*, 1987 at 148.

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THE INTERNATIONAL CHAMBER OF COMMERCE (ICC)

Critical Review of the OECD/Council of Europe Multilateral (Draft) Convention on Mutual Administrative Assistance in Tax Matters

By Jacoba Helfrich-Laubrock

INTRODUCTION

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 world-wide 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.

On the occasion of the *Bulletin's* Congress issue of 1986, the ICC received the opportunity of giving an account of the various taxation issues it pursues. Among the projects described, the ICC's strong criticism of the OECD/Council of Europe's draft convention on mutual administrative assistance in tax matters occupied a prominent place. Much attention has been given to the draft and its handling in both organisations within this past year. The ICC, therefore, is pleased to follow its last year's discussion of the topic with a more detailed description of its critical views.

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.

UNNECESSARY SECRECY

Throughout the more recent past, the International Chamber of Commerce has followed with increasing indignation the drafting of a new multilateral convention on mutual administrative assistance in tax matters within the organisation and framework of the OECD and the Council of Europe. Work on the draft, having started some 8 years ago, went unnoticed by international business at first, since no consultation of the taxpayers concerned took place, nor was any information on the ongoing project given. It was by informal channels rather than by official communication that the ICC obtained a copy of the draft in 1985, enabling this organisation of world industry to set forth its own views on the proposed convention.

This utmost secrecy accompanying the work on the draft provoked fervent criticism by the ICC. Undoubtedly, the neglect in consulting business on the envisaged scheme for a closer coordination of international tax authorities resulted in much broader criticism of the proposed treaty provisions than would have been the case if business views had been taken into at least some account at an early stage of the drafting work.

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NO NEED FOR A NEW CONVENTION

Besides being angered about the secrecy of the preparatory work on the convention, the ICC rejects the convention as being wholly superfluous. As the President of the ICC Tax Commission, Mr. Wolfgang Ritter, once stated in an interview: "We need this like we need a hole in the head". In the opinion of the ICC, sufficient international anti-tax evasion legislation is already in force. A European agreement, permitting close cooperation between the courts and fiscal authorities of different countries in combatting tax evasion has been in force since 1959. EC guidelines for fiscal cooperation drawn up in 1977 have also found their way into law in Member States. Along with a well-established network of bilateral and special fiscal agreements, these measures now provide for efficient joint tax control.

While the ICC does not object to reasonable fiscal cooperation, it clearly recognizes the danger that a multilateral convention granting such vast support to mutual international tax control will very likely undermine the importance of bilateral tax treaties. No new bilateral agreements for the avoidance of international double taxation would be sought, and it is to be feared that any such existing agreement might be terminated. In the end, the world-wide network of bilateral double taxation treaties, which was attained in tough and time consuming negotiations over decades, is likely to shrink or even wholly disappear.

This basic criticism of the draft convention in mind, the ICC prepared a detailed statement setting forth its objections to a fair number of the treaty's provisions. (The ICC statement is reproduced below.)

Foremost, criticism is aimed at the fact that the draft convention does not protect and sufficiently maintain the secrecy of the taxpayer's affairs; instead, fiscal authorities gain excessive rights to information. No rule of reason is laid down for what is tolerable for the taxpayer. Legal safeguards such as preliminary hearings, the prohibition of house searches, or effective business secrecy are virtually lacking.

If entering into force, the envisaged multilateral convention will do serious harm to business operations. The ICC anticipates international trade and investment to suffer. It, therefore, calls upon the countries concerned to reflect on the economic reasoning of their scheme.

LOBBYING EFFORTS AGAINST THE DRAFT

In its opposition to the draft convention, the ICC, among others, joined forces with the Business and Industry Advisory Committee to the OECD (BIAC) which lobbied against the draft within the OECD, whereas the International Chamber of Commerce primarily focussed its efforts on the Council of Europe as well as on national governments which are members of the two organisations.

There had been a particular lobbying blitz within the Federal Republic of Germany, resulting in repeated requests of the German Federal Government to delay a vote on the convention within the Council of Europe. The German Federal Government sought thus to gain time for better consultation of German industry on the draft. When a vote on the text of the convention finally was taken in April 1987, the ICC and German industry proved to have been successful in setting forth their objections: contrary to previous statements, the German Government voted against the text. It was joined by the Governments of Switzerland, Luxembourg and Liechtenstein. Three members of the Council of Europe cast a vote of abstention, whereas 11 countries voted in favour of it.

Thereby, the draft text of the convention was adopted with the deficiencies the ICC is criticizing. However, the final decision on the entering-into-force of the convention will not be taken before the end of June 1987. With only one negative vote, the convention would be vetoed alltogether.

The printer's deadline for submission of this article is too early to incorporate the results of this important vote into this account. There is no doubt, however, that the ICC will not cease in its efforts to bring about a positive result.

ICC statement on the OECD/Council of Europe draft "Multilateral Convention on Mutual Administrative Assistance in Tax Matters" (ICC Doc. No. 180/261 Rev.)

1. The Commission on Taxation of the International Chamber of Commerce has already given its initial reactions to the publication of the draft Convention in a letter dated 4 June 1985 from the ICC to the Council of Europe.
The Commission has now received copies of the draft Convention and welcomes the opportunity to comment on the published document.

2. It should be made clear that the International Chamber of Commerce is opposed to tax evasion and approves of governmental attempts to prevent fraudulent actions. The ICC regrets that no distinction has been made between the terms "tax avoidance" and "tax evasion". The ICC is of the opinion that the taxpayer has the right to minimize his tax burden by all legitimate means, and this should be recognized.

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The ICC underlines the need to maintain a balance between the fiscal authorities and taxpayers so that business relations can be left intact. It is worth repeating that if businesses are prevented from developing the fiscs themselves will suffer.

3. It is necessary to make a number of comments about the extent and nature of the draft Convention in the light of the ICC's general objectives which include the stimulation of world business by way of free movement of capital, goods and persons. ICC does not believe that these free movements have resulted in an increase of tax evasion.

3.1 There exists already an eloborate network of tax treaties between OECD countries. In addition, in Europe the EEC Directive No. 77/799 of 19 December 1977 provides for Mutual Administrative Assistance between members of the Community. We question the need therefore for any new Convention. In our view it has not been demonstrated that the existing instruments are inadequate.
With this further Convention, taxpayers will become subject to yet a further set of rules of quasi laws, and confusion is bound to be increased when different sets of laws are applied to the same basic sets of transactions.

3.2 An important aspect for business is certainty in the results of the transactions which are being undertaken. The Convention and the information flows which will result when it is implemented will generate additional uncertainty over a considerable period of time since the taxation results of transactions may not be clear for many years. This is particularly likely if no distinction is made between what constitutes avoidance and what constitutes evasion.

3.3 We consider it important that there should be no discrimination against multinational enterprises. There appears to be an underlying assumption that such organisations are by their nature given to tax evasion. We do not believe this to be so and this ought to be recognised by tax authorities.

3.4 The draft Convention extends obligations and rights below the Federal or Central Government level. We have strong reservations about this further development. Information received by a (Federal) Government should certainly not be passed on to its political subdivisions for the purpose of taxation not in accordance with general international taxation standards, e.g. (mandatory) unitary taxation with world-wide reporting.

3.5 The draft Convention has no defined standards for the information to be exchanged. ICC emphasizes the risk of unwarranted fishing expeditions of irrelevant information. Therefore it is absolutely necessary that the requesting State should clearly establish the relevance of the information requested. We seriously doubt whether the exchange of information provisions in the Convention would withstand any objective cost/benefit analysis. The provisions for spontaneous exchange in particular could be expected to result in due course in an enormous multidirectional paper flow, much of which there is no reason to suppose will be of relevance or will in consequence be productive of greater Government revenues. What may be regarded as pertinent and necessary information in one country will not be so regarded in another. The result would be to impose on business and industry, without proper justification, a considerable administrative cost in dealing with questions prompted by the information flow.

3.6 There is a basic principle of "self-help" which should be encouraged in the Convention. Assistance should not be sought or given until the State seeking information has exhausted all the possibilities within its own control.

3.7 There should be an inalienable right to double taxation relief if or where the taxation results are adjusted in the light of information transferred from one to another. As States might use the present Convention to increase their tax revenues, conflicts of interest will arise between the various fiscs. Corresponding adjustments are necessary so that taxpayers do not suffer double taxation.
We note that in the present case the Convention makes only an allusion in its preamble to appropriate protection against discrimination and double taxation. The provisions of the Convention, however, omit this question totally. This reinforces the case for a mutual agreement procedure which obliges the States involved to reach a solution effectively preventing double taxation.

3.8 Apart from the safeguard against double taxation mentioned above, it is essential to have an arbitration procedure above the level of the individual States and their competent authorities to determine the situation where there are disputes which cannot be settled to the satisfaction of both the States and the taxpayers involved.
If information must be transferred, under the rules of this Convention, with the consequent derogation of sovereignty, then the argument frequently advanced by States that the setting up of an Arbitration Court is a derogation of their sovereignty, and therefore cannot be accepted, no longer appears valid.

3.9 The rights of the taxpayers need to be protected to a far greater extent than is indicated in the document.
It is essential that a taxpayer be notified of any request for information and that he should be able to challenge the propriety of that request in the context of the local system of the re-

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quested or requesting country. Under the law of some countries, it is already the situation and, in the absence of such a provision in the Convention, it is difficult to see how such countries could participate.

3.10 We consider that the businessman's requirement for confidentiality with regard to trade secrets, know-how, etc. must be protected. It would be unacceptable for such secrets to be at risk. Where the standards of confidentiality in the requesting State are inferior to those in the requested State, information would not be provided.
The information transfer to the fiscs of Governments which may themselves have nationalised industries trading in the same area as the taxpayer or where, in any event, severe competition from members of the recipient country is met in the market place should be regarded as being at risk for this purpose. In the ICC's view the transmission of information must be limited to the fiscal administration only and should only be used for tax purposes.

3.11 While from the point of view of fiscs, it may be thought that the interchange of information will reduce tax evasion and avoidance, it should be recognised that the knowledge that information about transactions may be transferred to various Governments means that taxpayers will be inhibited from entering into transactions and that as a result international commerce will suffer.

SWISS BRANCH

1986 Report

The number of individual member increased from 314 to 327 and corporate membership from 77 to 78.

In 1986 the Swiss Branch of IFA met on 7 February, 13 June and 6 November. Apart from organizational matters, recent national and international tax problems were discussed.

Meeting of 7 February

The subject discussed was the principles underlying a Swiss tax treaty policy. Mr. R. Lenz (attorney in Geneva) gave an introduction to the history of tax treaty policy and Mr. D. Lüthi (Vice-Director of the Federal Tax Service) lectured on the present situation and expected developments. A panel discussion chaired by Mr. M.B. Ludwig (President of the Swiss Branch) followed the lectures.

Meeting of 13 June

During the meeting of 13 June, Professor Dr. J.M. Rivier was elected President of the Swiss Branch and Dr. A. Buckhardt Vice-President. Dr. M. Desax (attorney in Zürich), P. Spori (Director ATAG, Allgemeine Treuhand AG) and D. Metzger (Director of the Federal Tax Service) were appointed as new members of the Board.

Following the organizational part of the meeting, tax problems connected with loan financing of enterprises were discussed. Dr. R. Kögler (director of the Association of Swiss enterprises in the Federal Republic of Germany) gave a talk on the developments in Germany. Dr. C. Sockar, Head of the Legal Service and Deputy Head of the Division for Stamp Duties and Withholding Tax of the Federal Tax Service, lectured on withholding tax problems connected with loan financing. Dr. K. Beer, Deputy Director of the Cantonal Tax Service, discussed the problems concerning disguised equity capital and direct taxation.

Meeting of 6 November

After a brief discussion of the 1986 New York IFA Congress, the subjects of the 1987 Brussels Congress were presented by the Reporters, i.e. Dr. S. Zimmermann (attorney in Zürich) who dealt with Subject I (the fiscal residence of companies) and Dr. H.U. Freimüller and Dr. N. Burki who were responsible for the analysis of subject II (tax problems of the liquidation of companies).

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Tax Reform in Liechtenstein

By Dr. Norbert Seeger*

I. INTRODUCTION

Originally, Liechtenstein had a system of tax on capital. Income tax had only a supplementary function. This system was introduced when most income was derived from agriculture but, as will be shown in this article, this system helped to develop the economy.

Liechtenstein is, however, now a prosperous country with a high national income. It was able, by industrialization, to overcome the great disadvantages of being a mountainous country completely bare of raw materials. Liechtenstein is now a country with a highly specialized and very successful export industry and has also become an international service centre. Unemployment is unknown.

For quite some time now it has therefore been considered that a tax system based on the taxation of income would be fairer since it is no longer necessary to assume that most income is derived from capital. However, the present tax law does not have such great imperfections as one might expect would result from the application of a strict capital tax system to a modern economy. In general, all income will indeed be taxable, even if only indirectly, as in the case of income derived from capital. Nevertheless, it cannot be denied that, in spite of relatively high tax rates on capital assets, income derived from capital has so far, to some extent, been privileged income.

In 1975 the Liechtenstein Government therefore took the first steps towards a changeover to the general income tax system. A first draft was produced in 1983, intended to lead to consultation with all interested parties.

Such consultations organized by the Government have, however, shown that the capital tax system is not generally considered to be particularly inequitable as it suits taxpayers of all income groups. To have a house of his own and also some savings is still the chief material aim of the average Liechtensteiner. Given the present high standard of earnings, this aim is reached by the great majority of Liechtensteiners. This being so, those consultations tended to concentrate on the question of providing greater equality of opportunity for married couples and young entrepreneurs. The most noteworthy result of those consultations was probably to suggest the introduction of a separate rate of tax for married couples and for parents living with their children in the same household.

The 1985 draft, which incorporates many of the proposals made during consultations, resulted in a balanced compromise between all the main interests. This article is based on that draft. The first section deals with the history and the primary objectives of the proposed legislation. The second section will discuss the taxation of individuals under the new draft. It focuses on the changeover to the income tax system and on the separate tax rates applicable to married couples and to single parents living in the same household with their children. The final section deals with corporation taxes in relation to which one of the main questions at issue is the double tax burden on corporation profits.

As the democratic constitution of Liechtenstein provides for the holding of referenda and any major law reform must be approved by a referendum, it follows that such consultation is fundamental. At present, the Government is still reviewing the last draft. According to the agenda, a bill will be submitted to the Liechtenstein Parliament in the near future. Liechtenstein is in the privileged position of continually being able to balance its Budget and to produce annual surpluses. Liechtenstein will therefore remain a country with relatively low taxation. Major tax privileges, intended to promote free enterprise, will continue in force.

Dr. Seeger received his Licentiate of Economics from the St. Gallen School of Economics in 1978. In 1980 he was graduated from the University of Berne with his Licentiate of Laws and in 1986 he was conferred his Doctor of Laws.
Since 1984 he has been a practicing attorney with the firm of Alfred Bühler in Vaduz, Liechtenstein.

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* I would like to thank my colleague, Mr. W.D. Conolly, M.A., Cantab, Solicitor, for assistance with the English translation.

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II. HISTORY

The Liechtenstein Tax Authorities first imposed taxes in the 18th and 19th centuries. At first, these taxes were mainly on land, but later also on personal property. The principal source of tax revenue, however, consisted of indirect taxes. Apart from the taxes on land, from 1865 to 1922, there were imposed income taxes and taxes on buildings, trade, capital assets and earnings.

Following an Act passed on 11 January 1923, Liechtenstein adopted the system of a general capital tax with a supplementary income tax. Ideally, the capital tax system with its low tax rates was to protect capital and to promote the creation and earning of new capital. This liberal policy was a bold response to the financial collapse following the First World War which also affected neutral Liechtenstein because the currency of Liechtenstein was then that of Austria. Due to the low tax rates a number of foreign individuals and companies established themselves in Liechtenstein, and several young Liechtensteiners set up small industries which grew.

III. THE STATE AND COMMUNAL TAXES ACT OF 30 JANUARY 1961

The 1961 Tax Act, like the 1923 Tax Act, was based on the system of general assets tax with supplementary income tax. Individuals are subject to assets as well as supplementary income tax, which in certain cases is replaced by a pension tax. For corporate entities, the present tax law imposes a corporation tax. According to the nature of the business of a company either capital and income tax or reduced rates of corporation tax are applicable. Land tax on gains from the disposal of land is supplementary since capital gains, in principle, are not taxable under the capital tax system. Apart from these main taxes the present Tax Act also provides for inheritance taxes, gifts tax, alcohol tax and motor vehicle tax.

The Tax Act, which came into force in 1961, has since been amended several times in the light of changing economic situations. The amount of permitted deductions from assessable income was periodically increased. Progressive tax rates were reduced to meet inflation. In 1967, taxation of company dividends at source was introduced. The special corporation tax for holding and domiciliary companies was increased in addition to tax rates for inland trading companies. As from 1972 the income of migrant workers was made taxable and remains so.

IV. PRIMARY OBJECTIVES OF THE TAX REFORM

In 1975 the Liechtenstein Government commissioned the Institute for Fiscal Policy and Fiscal Legislation of the St. Gallen School of Economics, St. Gallen, Switzerland, to undertake a study on the basic problems of totally reforming the Liechtenstein Tax Law. The focal point of the study was to be a survey of problems resulting from a proposed introduction of a general income tax system. The Institute presented its first outlines of a new tax law in the autumn of 1975 and produced various alternatives for the statutory regulation of the different standard ways of charging tax. After a review of the proposals the Government asked the Institute to submit a detailed report on the basic problems and to formulate its first draft outlining its propositions for the new Tax Act. In the autumn of 1976 there was available to the Government a comprehensive basic draft which formed the subject of further discussion in the Government. A preliminary decision had to be taken on the introduction of taxation at source of income arising from capital assets other than land. The Government, after consideration of the advantages and disadvantages decided, however, to drop the proposal for taxation at source.

In November 1983 the Government presented a "green paper" concerning the draft of a new Tax Act which was to serve as a guide for consultation involving all groups. This draft is based on the *system of general income tax*. The proposed new rules fix on the income of the person. The total income arising to a natural person during one year, irrespective of source, is accordingly subjected to income tax. Not only income earned from employment and social or other benefits such as pensions and annuities is liable to this income tax, but also income earned from capital assets, which is a substantial extension of the basis of assessment. In compensation for this, the tax on capital loses its importance. It would, therefore, merely become a supplementary tax. However, the change-over to this system of general income tax does not mean that all receipts arising from capital would be subject to income tax in the future. Irregular products of capital such as inheritances, bequests and profits from the sale of land should remain taxable by virtue of a special tax to be assessed separately in order to avoid peak tax years due to progressive rates and to take reasonable account of special family relationships, the length of time a property is owned and other aspects of taxation principles.

The corporation tax for corporate entities having a permanent establishment in Liechtenstein will take account of the new rules about distribution of profits.

Such distribution will be taxable as income in the hands of inland shareholders. For this reason the abolition of coupon tax for residents of Liechtenstein is justified as is also the reduction in the maximum rates of corporation tax.

V. THE 1985 DRAFT OF THE NEW TAX ACT

The 1983 draft, which was the basis for consultation, was criticized for creating and upholding inequitable solutions. The Government had to admit that a change of system alone could not guarantee equitable taxation and in its last draft, which was released in 1985, far-

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reaching remedies were introduced. Under the 1985 draft married couples will be taxed at lower rates and, to counter the double tax burden on corporation profits, the corporation tax rate was lowered. Thus, the prospects for the proposed legislation to find approval in a national referendum have improved.

The 1985 draft, as does the present law, distinguishes between State Taxes on the one hand and Communal Taxes on the other.

The following State Taxes would be imposed:

(a) An income and assets tax on natural persons and on certain property, which is to be treated as if it were a natural person.
(b) A profits and capital tax on juristic persons and other similar undertakings. The tax privileged holding and domiciliary companies are exempt from this general corporation tax. However, in the place of this tax will be imposed on domiciliary and holding companies tax on capital and, if the capital of such a company is divided into shares, a coupon tax. A tax on premium earnings will be imposed on foreign insurance companies.
(c) A tax on gains from the sale of land.
(d) Inheritance taxes and gifts tax.
(e) Motor vehicle tax.

The communal taxes consist of a supplement in favour of the communes which is added to their share of the taxes, raised or received by the State, and also consist of the taxes on households and dogs which communes may impose in their own right.

1. Taxation of individuals

The most substantial item of reform in the draft is the introduction of a general income tax for natural persons. All income, whether recurring or otherwise, including income received in kind, is liable to income tax, in particular the following incomes:

Income from employment (offices and pensions)

Income arising from a contract of employment, whether in the private or the public sector, and including any emoluments and additional benefits whether in cash or in kind (payments for special services, perquisites, loyalty bonuses, employees' shares, commissions, gratuities, tips and all other payments in cash or in kind received for work or services), and also including extra-allowances for attendance at business meetings.

Income from entrepreneurial activities (trade, profession or vocation)

Income from self-employment, a profession and any other self-employed activity; including capital gains arising from any sale, exploitation or increased valuation as shown on the accounts of movable business assets and on the transfer to private ownership of business assets taking into account the depreciations allowed. Sales subject to land sales tax are excluded.

According to the present law any income arising from capital which is liable to capital tax is exempt from any direct taxation. In contrast to this, the draft contains the principle according to which any income from capital, whether from movable or immovable assets, is liable to income tax. This is the necessary consequence of the change-over to the system of general income tax with capital tax having a supplementary function. According to the draft all income arising from capital is taxable. The following is considered to be income derived from movable property:

(a) Any interest including bank interest.
(b) Dividends and other shares of profits, surpluses arising from liquidations and all other transfers of rights having money value whether emanating from participation or beneficial interests.
(c) Rent arising from tenancy agreements, leasing, licences or any other exploitation of movable property and other gainfully exploitable rights.
(d) Income arising from intellectual property, e.g. choses in action, patents, designs, copyrights, trade marks.

Income from immovable property in particular means income from rent, i.e. from tenancies, whether short or long-term, and also from any exploitation of land carried out by the landowner or his contractual partners.

As a matter of social policy, pensions and other similar recurring payments should only be included in taxable income to a limited extent.

Other receipts such as redundancy payments, gains from lotteries and similar activities are also taxable, unless subject to some foreign tax. Moreover, maintenance payments and benefits received from private and family foundations are taxable.

The following income is – among other things – not subject to income tax:

(a) Income from business undertakings situated abroad but owned by residents of Liechtenstein.
(b) Non-recurring capital transfers such as inheritances, bequests and gifts.
(c) Capital receipts from life, accident and other capital insurances.
(d) Damages and compensation payments made in consequence of personal injuries and illness, payments for maintenance and support of the needy, education purposes as well as other income exempt from taxation as a matter of public policy.
(e) Income from foreign land.

Under the new income tax system net income from both movable assets and land would be taxable.

Upon the change-over to the system of general income tax the present method of tax computation will become obsolete.

According to the present law the assessment of tax liability is thus effected that the amounts of capital tax and supplementary income tax are added together and increased by a supplement to the progressive scale. The extent of tax rate progression is thus determined

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by the sum of capital tax and supplementary income tax. According to the proposed new regulations, income tax and capital tax are computed separately so as to avoid unequal treatment of like amounts of income by dropping the distinction between income from capital and other income. The new draft also provides for progressive tax rates for income tax.

Under the new draft two different scales of tax rates will be introduced. Scale A for single persons and Scale B for married couples and single parents living in the same household with their children. The rates for married couples will, up to an income of 60,000 Sfrs., be at least 30% lower than the rates for single persons. This proposal is indeed a very generous solution of the long criticized unequal treatment of the income of married couples.

Comparative table of tax rates:

Net income p.a. in Sfrs.	*Tax liability present rates of net income*	*Scale A Proposed percentage for single persons*	*Scale B Proposed percentage for couples*
20,000	6.51%	4.35%	2.88%
30,000	8.40%	6.00%	4.20%
40,000	9.45%	7.35%	5.14%
50,000	10.50%	8.40%	5.88%
60,000	11.35%	9.30%	6.59%
70,000	12.39%	10.20%	7.47%
80,000	13.02%	10.95%	8.24%
90,000	13.65%	11.70%	9.04%
100,000	14.28%	12.30%	9.70%
110,000	14.91%	12.90%	10.38%
120,000	15.33%	13.50%	11.07%
130,000	15.96%	14.10%	11.80%
140,000	16.59%	14.70%	12.53%
150,000	17.01%	15.15%	13.09%
160,000	17.43%	15.75%	13.87%
170,000	17.85%	16.20%	14.46%
180,000	17.85%	16.65%	15.05%
190,000	17.85%	17.10%	15.68%
200,000	17.85%	17.55%	16.30%
210,000	17.85%	18.00%	18.00%
220,000	17.85%	18.00%	18.00%

According to the general income tax system, the capital tax will only have a supplementary function since income arising from capital will be treated as taxable income. The reduced importance of capital tax is emphasized in the draft by the exemption from tax of various types of property by the fact that relatively high deductions may be made, that the total amount of assets will no longer influence the progression of income tax rates and that the capital tax rate has now been made proportional instead of progressive. The principle of the taxation of net assets corresponds in general to the present law. Analogous to the redefining of taxable income, it has in principle been laid down that all inland assets are subject to capital tax, namely:

- The market value of land and water power.
- The market value of securities and book debts at the end of the fiscal year respectively.
- The purchasing or production costs of raw materials, products and semi-manufactured products at their market value if the latter is lower than the production or purchasing costs.
- The contemporary market value of claims arising from recurring services and equitable rights.
- Life insurance policies.
- Intellectual property, e.g. choses in action, patents, designs, copyrights and trade marks.

The rate of capital tax will be a uniform 0,3% including an extra percentage of 200% for local authorities. The following tax deductions from net assessed capital would be permitted:

(a) 100,000 Sfrs. for married couples as well as for single parents living in one household with their children.
(b) 50,000 Sfrs. for all other taxpayers.

2. Taxation of juristic entities

As in the present law the draft provides for two different categories of taxable juristic entities:

(a) As a general rule a juristic entity is subject to capital and income tax.
(b) Certain legal persons, namely holding and domiciliary companies as well as foreign insurance companies, will have to pay a special corporation tax instead of income and capital taxes. Coupon tax (withholding tax) will remain in force for all holding and domiciliary companies, the capital of which is subdivided into shares.

The distinction between the two categories of companies will, in contrast to the present law, be removed as follows: all juristic persons in which Liechtenstein residents have shares or which have certain inland business connections are subject to ordinary income and capital tax. Thus, the privilege granted to holding and domiciliary companies will be limited to companies with exclusive foreign shareholding and which have no inland business links. In particular, this restrictive measure should contribute to the reduction of avoidance of ordinary taxation by resident individuals.

The draft is also proposing a new name for "holding and domiciliary companies". The new denomination is based on the activity of privileged companies, which within Liechtenstein is of an administrative nature only. Therefore, the draft calls companies which transact business along commercial lines "administration companies" and companies which transact no commercial business and are merely holding assets, "asset administration companies".

All companies of which the central management and control is in Liechtenstein are generally subject to income and capital tax. This provision not only includes companies existing under the laws of Liechtenstein, but also foreign companies, which have either their registered office or actual management in Liechtenstein. This principle, however, in line with the present law, is considerably restricted since administration and asset administration companies (formerly called holding and domiciliary companies) will not be subject to the general income and capital tax.

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Income and capital tax liability will therefore be extended to all juristic entities with a registered office or management in Liechtenstein if they have business connections with Liechtenstein, and this will be the case if the juristic entity:
- is controlled by residents of Liechtenstein;
- has close business connections with Liechtenstein;
- acts as a money lender in Liechtenstein;
- owns land in Liechtenstein; and
- has shares in a Liechtenstein company.

The entire net profit of a juristic entity including capital gains and hidden distributions of profits to natural persons connected with the company are chargeable. Investment capital by members of share capital companies and associations, including share premiums, transfers of the registered office to another country, not affecting business results, capital gains arising from inheritances, bequests or gifts as well as profits from measures taken to avoid the insolvency of a company, are exempt from income tax. Following the principle of realization, capital allowances for depreciations are also exempt from tax provided that they consist of replacements of assets, changes of corporate form or mergers.

It is proposed that income tax on juristic entities will be levied at proportional rates, namely as a general rule at 10% of net taxable income. The tax rate is, as under the present law, based on the ratio between the taxable profit and the equity capital of a company. The tax rate is half of this ratio. However, there would be a minimum rate of 6% and a maximum rate of 12%. Under the present Act the minimum rate of 7.5% and the maximum rate is 15%, with the rate being increased proportionally if 1% or more of the distributed profits exceed 8% of the taxable capital. In the draft this proportional rate of increase is dropped.

Under the present law payments of shareholders in a share capital company (dividends, shares of profits, surpluses on liquidation) constitute income arising from capital not subject to income tax and are therefore (apart from the 4% coupon tax) not taxable.

The rates for corporate income tax have been lowered in the draft to alleviate the effect of the well-known double taxation of distributed profits, a side-effect of the introduction of the income tax system. The present system, where, in principle, income from capital is not taxable, avoids this problem. As a further relief, the draft dropped the 4% coupon tax, which is a sort of withholding tax on distributions. The rates, which are proportional in relation to the profitability of the company, are meant to favour re-investment, and to follow also the principle of taxation according to ability-to-pay. A further relief is provided by the exemption from corporation tax of distributions received from Liechtenstein companies. According to international practice this exemption is, in the case of foreign shareholdings and participations, only granted if they are substantial, i.e. 20% of the issued capital or a taxable value of at least 2 million Sfrs.

This double taxation of distributed profits met with great criticism during consultations. The draft basically adopts the classical system with all its known disadvantages, which it only tries to moderate with particular relief measures.

The proportional rates will not only further re-investment, but may also distort efficient allocation of capital and, more importantly perhaps, create a preference for loan capital over equity capital, because interest, unlike dividends, is deductible for tax purposes. The exemption of participations merely avoids a triple taxation of the same company profit.

Given the weight of these arguments and the relatively inefficient corrective measures proposed, it is to be expected that in parliamentary discussion the problem of this double tax burden will lead to an introduction of dividend reliefs or some other form of alleviation.

Capital tax on corporations has been designed as a tax supplementary to the general income tax. The net equity of a company – being a juristic entity – is chargeable. Furthermore, capital allowances exempt from income tax are also exempted from capital tax. The rate of capital tax will be reduced from .2% to .1% which emphasizes the supplementary character of this tax and represents an approximation to the method of taxing, holding and domiciliary companies.

The provisions concerning *administration and asset administration companies* are, in principle, not affected by the tax reform.

However, in order to avoid fraud, provisions granting the tax privilege were restricted so that only companies controlled entirely by non-residents or where only non-residents are beneficiaries, are entitled to the privilege. As stated above, no tax privilege is granted if there are business connections with Liechtenstein. Should such connections exist the company will be subjected to the ordinary income and capital taxes.

The capital tax rate for administration and asset administration companies will be reduced from .1% to .05% of the net assets with a minimum tax of 1,000 Sfrs. For foundations the present reductions have been reduced and extended to asset administration companies: capital tax rate is reduced to .05% of the net assets up to 2 million Sfrs. and to .025% for net assets of over 2 million Sfrs.

Apart from capital tax the draft also provides for the 4% coupon tax to remain in force with regard to administration and asset administration companies. It taxes the distributions of profits to holders of participations in companies of which the capital is divided into shares.

3. Tax on capital gains from the sale of land

In line with the present provisions, capital gains from the sale of land will also be submitted to a special income tax under the new regulations. The draft does not distinguish between land which is part of private assets and land which is part of company assets, but taxes all capital gains from the sale of land which are so regarded by the law of property. The following also count as dispositions:

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(a) any transaction affecting the enjoyment of ownership of such land as a transfer of ownership;
(b) the acquisition of privately owned land by juristic entities as a consequence of the formation of a juristic entity or of an increase in the capital thereof to the extent that the book value exceeds the costs of such formation or increase in capital; and
(c) the imposition of burdens on land as a matter of private right or by reason of restriction on rights of ownership created by public authorities to the extent that they permanently restrict the exclusive enjoyment of the rights of disposition and if such restrictions have been the subject of compensation.

Income from letting, leasing or other exploitation of land is not subject to this tax, but rather to income tax.

The taxable gain is the excess of the net sales proceeds over the cost of acquisition together with all expenditure on the land or on the buildings thereon which increases value. Acquisition of any investments in property are added to the purchasing price. Gains from the sale of land are assessed at income tax rates.

To counter speculation in land, a higher tax rate is applicable if the property was only held for a short time.

4. Estate duty, inheritance and gift tax

Inheritance and gift taxes are the so-called capital transfer taxes; they tax the transfer of assets from the estate of the donor to the heirs or donees. The value of the transferred assets is subject to taxation. The rate is determined by family relationships.

Taxes are levied on:
The estate in so far as it comes under the jurisdiction of the Liechtenstein courts; this excludes land situated in other countries and other property held abroad, but includes any property left by an individual residing abroad which necessitates taxation in Liechtenstein; the estate tax is levied on the residuary estate.

Inheritance tax is imposed on capital transfers due to inheritance arising in Liechtenstein by virtue of wills, intestacy or donations mortis causae as well as other assets of the deceased arising from a contract in favour of a third party (life insurance, annuities, etc.); the inheritance tax is levied on the heirs.

Gift tax is imposed on any gift inter vivos made within Liechtenstein.

The heirs are liable to pay the estate duties. Their liability includes taxes on bequests and other capital related transfers. The donee has to pay the gift tax. The donor as well as the donee are liable jointly and severally.

The estate duties are as follows:

1% on the first	200,000 Sfrs.
2% on the next	400,000 Sfrs.
3% on the next	600,000 Sfrs.
4% on the next	800,000 Sfrs.

5% on the residue of the estate exceeding 2 million Sfrs.

This estate duty is assessed at half of the above rates should the estate be transferred to a surviving spouse, children or parents.

Gift tax and estate devolution tax (inheritance tax) are levied at the following rates:

- ½% for gifts and inheritances to children, including adopted children, grandchildren and parents as well as spouses;
- 2% for inheritances and gifts to grandparents and siblings;
- 5% for inheritances and gifts to step-children, children of in-laws, nieces and nephews;
- 9% for inheritances and gifts to aunts and uncles;
- 12% for inheritances and gifts to other next of kin and in-laws twice removed; and
- 18% for inheritances and gifts to all other persons.

5. Motor vehicle tax

A tax is imposed on all motor vehicles circulating on public roads. Each car owner is liable to motor vehicle tax.

Vehicles with catalisators and motor cars where the exhaust does not exceed certain limits are exempt from motor vehicle tax up to 31 December 1989.

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INDIA:

Tax Treatment of Payments under Foreign Collaboration Agreements

By Har Govind

INTRODUCTION

Business activities of foreign companies in India give rise to three important categories of problems. The first type relates to the taxation of foreign companies themselves. The second category covers questions arising our of tax evasion or avoidance by multinationals. The third and last group of issues pertain to questions of admissibility, for tax purposes, in the hands of Indian companies, of payments made by them under foreign collaboration agreements. Problems of the first two kinds have already been dealt with by this author in earlier studies published in this journal.[1]

This article discusses questions of deductions for tax purposes of payments made by Indian participants to foreign companies under collaboration agreements.

TECHNOLOGY POLICY

The basic objective of the technology policy as expounded at page 22 of the 1985-86 Report of the Department of Industrial Development is the development of indigenous technology and efficient absorption and adaptation of imported technology consistent with national priorities and resources. The main aims of the technology policy may be summed up as: (1) attainment of technological competence and self-reliance; (ii) provision of maximum gainful employment to all strata of society; (iii) maximum development with minimum capital outlay; (iv) identification of obsolescence of technology in use and (v) development of technologies which are internationally competitive, particulary in the field of export potential.

The Indian Government has listed certain industries in which no foreign financial or technical collaboration is permitted. However, import of technology is permitted under certain special circumstances like:

(i) if the technology is too closely-held and is not available for use by entrepreneurs on competitive terms;
(ii) if the technology is required for updating existing technology to meet higher domestic requirements or to become competitive in export market; or
(iii) for manufacture of items with substantial export potential backed by buy-back guarantees.

FOREIGN INVESTMENT

India considers foreign investment in principle as a vehicle for the transfer of technology to the country. Foreign investment, not accompanied by foreign technology, is normally not allowed. The two exceptions are investors from Oil Exporting Developing (OED) countries and non-residents of Indian origin. These two categories of investors are allowed to invest up to specified limits and under certain stipulated conditions, even though there is no transfer of technology along with the investment. The normal ceiling for foreign investment is 40% of the total equity capital. A higher percentage of foreign equity can be considered if the venture is largely export-oriented. For wholly export-oriented units foreign equity of even 100% may be allowed. The foreign share capital should be contributed in cash without being linked to imports of machinery and equipment or payment for know-how, trade marks or brand names.

GROWTH OF COLLABORATIONS

The figures of foreign collaboration approvals in main industrial areas in 1985 as compared to 1983 may be seen from the following table:

Table I

Industry	*No. of approvals* 1985	1983
1. Electrical equipment	205	129
2. Industrial machinery	152	115
3. Chemicals (other than fertilizers)	69	62
4. Metallurgical industries	53	20
5. Industrial instruments	52	37
6. Machine tools	32	44
7. Ceramics	27	21
8. Other industries	434	245
Total	1,024	673

1. For general background material, reference may be made to the following two articles:
1. India: "Taxation of Foreign Companies": 38 *Bulletin for International Fiscal Documentation* 12 (1984) at 536;
2. India: "Measures against Tax Evasion by Multinationals": 39 *Bulletin for International Fiscal Documentation* 10 (1986) at 302.

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The above statistics shows that during the period 1983-85 the approvals of foreign collaboration agreements has registered an increase of more than 52%, which is quite high. The share of various countries in agreements approved in 1985 in terms of value is as per table below:

Table II

Country	*Quantum of investment* (100,000 Rs.)
USA	3,993
Japan	1,568
Germany (Fed. Rep.)	1,181
Italy	695
Norway	650
United Kingdom	371
Belgium	268
Canada	247
France	236
Others	3,378
Total:	12,587

The figures in the above two tables show that collaboration agreements between India and foreign countries, particularly with Western Europe and North America are steadily growing both in terms of numbers and value.

SCRUTINY OF AGREEMENTS

Under foreign collaboration agreements Indian parties have to make payments for import of sophisticated technology. These payments take many forms like royalties, technical services fees, dividends, interest, a percentage of turnover or profits and mixed permutations and combinations of these forms. These payments involve remittance of money out of India and affect the country's foreign exchange resources. India is facing an adverse trade balance of more than 50,000 Rs. since 1980-81. The latest figures published by the Reserve Bank of India place the adverse balance of trade at the end of 1985-86 around 80,000 million Rs., which is an all-time record. Amongst others, the adverse trade balance is naturally one of the factors for the Indian Government's selective and cautious approach in the matter of approval of foreign collaboration agreements. Against this general background, the Income-tax Department also applies a closer scrutiny to claims of admissibility of payments made by Indian parties in their tax returns. The agreements involve various types of subtle ingenuities in drafting and varied forms or modes of payments. This has led to differences in perception between taxpayers and tax authorities and has thrown up a mass of case law evolved by Courts.

PAYMENT: REVENUE OR CAPITAL?

The dispute regarding the deductibility of either the whole or part of payment under a foreign collaboration agreement ultimately boils down to the question whether it is a capital expenditure or revenue disbursement? The leading authority for determination of this question which is holding the field since 1926 is Viscount Cave's celebrated dictum in British Insulated and Helsby Cables Ltd. v. Atherton 10 TC 155: (1926) AC 205.

He observed:

> "When an expenditure is made, not only for once and for all but with a view to bringing into existence an asset or an advantage for the enduring benefit of the trade, there is very good reason for treating such an expenditure as properly attributable not to revenue but to capital."

Each payment under a foreign collaboration agreement is therefore examined with the touchstone of the "enduring benefit" test. If the payment brings into existence an asset or advantage of enduring benefit it is capital in nature and is not deductible as a revenue expenditure. The outcome of the enduring benefit test often depends on the drafting of the agreement in each individual case.

LANGUAGE OF AGREEMENT

The drafting of clauses of an agreement setting out the terms and conditions of collaboration is very important. It should be done with great care and expert advice. Sometimes the collaboration agreements are not properly worded. Generally, a foreign collaborator does not part with the technical know-how absolutely. He merely grants a licence to use it. Still, in some cases, the clauses of the agreements give an impression that there is an outright sale of know-how. The case of Triveni Engineering Works offers a good illustrative example.

An Indian company, Triveni Engineering Works Ltd., was set up to manufacture steam turbines. It did not possess the technical know-how or the expertise for this purpose. The technology was obtained from Brotherhoods Ltd. of the United Kingdom in the form of drawings, designs and know-how. Clause 2 of the agreement mentioned that Brotherhoods would "sell outright" to Triveni the technical know-how in respect of steam turbines. According to clause 3, technical information, designs and drawings which are provided to Triveni would be its "absolute property". In view of these words in the agreement and the fact that the expenditure was of an initial nature inasmuch as the Indian company had obtained the know-how for starting its business, the Income-tax Officer had disallowed the deduction of the payment as capital expenditure. When the case came up before the Delhi High Court, the ruling of the High Court in the Triveni Engineering Works Ltd. v. CIT (1982)136 Income-tax Reports (ITR) 340 (Delhi) was in favour of the company. The High Court examined the agreement carefully and noted the following facts:

- The agreement was for a period of 10 years. It could be terminated "forthwith" in certain circumstances.
- The agreement was limited to territories of India. Triveni had exclusive right of use.

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- Although the data, drawings, documents and dies supplied to Triveni was said to be its absolute property, the copyright in the above remained vested in Brotherhoods, the assessee having only a licence to use the property during the duration of the agreement.
- The assessee had to observe complete confidentiality. It could not disclose any information regarding the know-how without written consent.
- The assessee could not assign the agreement without written permission.
- The assessee had to inform Brotherhoods of any improvements developed by it. Brotherhoods could use these under certain conditions.
- Payment for use of know-how to design and manufacture steam turbines was made in a lump sum. The business of the assessee was new. However, the information and know-how to be imparted was to be spread over the period of the agreement.

After examining the clauses of the agreement in their totality the High Court held for the assessee. It said that although on a cursory reading the agreement gave the impression that technical know-how was sold absolutely, a careful and closer study of the agreement as a whole made it clear that despite the use of the words "agree to sell outright to Triveni" the agreement, in substance, was more in the nature of a licensing agreement. The High Court held that the technical know-how fees were deductible as revenue expenditure in computing the taxable income of Triveni. This specific case underscores the importance of drafting language. If the agreement were drafted more happily considerable litigation cost and time would have been saved.

SUPREME COURT ON COLLABORATION AGREEMENTS

The Supreme Court of India has enunciated the principles for interpretation of collaboration agreements in the case of CIT v. Ciba of India Ltd. (1968) 69 ITR 692 (SC). According to this decision it must be examined whether the agreement merely gives the right to the assessee to draw upon the technical knowledge of the collaborator for a limited period for the purpose of carrying on its business of manufacture by making the technical knowledge available? Or does the collaborator part with an asset of its business as a result of which the assessee acquires an asset or advantage of enduring nature for the benefit of its business? The Supreme Court analysed the agreement and noted the following important facts:

- The object of the agreement between Ciba of India Ltd., an Indian subsidiary of Ciba Ltd. of Basle, Switzerland, was to obtain the benefit of technical assistance from the Swiss company for running the business of the Indian company.
- The licence was for a period of 5 years. It could be terminated in certain circumstances even before the expiry of that period.
- The licence was granted to the assessee subject to rights actually granted or which might be granted after the date of the agreement, to other persons.
- The assessee was expressly prohibited from divulging confidential information to third parties without the consent of the Swiss company.
- For the right to receive scientific and technical assistance the assessee had agreed to make contributions of 5%, 3% and 2%, respectively, of the net sale price of the products sold by the assessee towards (a) technical consultancy and technical service rendered and research work done; (b) cost of raw material used for experimental work; and (c) royalties on trade marks used by the assessee. These stipulated payments were recurrent, dependent upon sales and only for the period of the agreement.

On the basis of the above facts, the Supreme Court held that it could not be said that the Swiss company had parted with the technical knowledge absolutely in favour of the assessee. The facts clearly established that the secret processes were not sold by the Swiss company to the assessee. Accordingly, the Supreme Court decided that the contribution made by the assessee to the Swiss company was allowable in full under Section 10(2)(xv) of the 1922 Act, corresponding to Section 37 of the Income-tax Act, 1961.

USE OF KNOW-HOW WITHOUT TIME LIMIT

It will be seen from the cases discussed above and below that restrictions placed by the collaborator regarding (i) the divulgence of confidential information to third parties; (ii) the assignment of agreements to third parties; (iii) the territorial operation; and (iv) the time-limit on use of know-how tend to strengthen the case that there is no full or partial sale of the know-how and the payment made for it must be deductible as revenue expenditure. At present agreements for use of know-how without any time-limit do not appear to be in vogue. In fact such agreements are not popular. With the present pace of scientific and technological development, technological know-how becomes rapidly obsolete. There is one reported case which merits a brief mention.

A registered firm carrying on the business of manufacture and sale of saccharine entered into an agreement with the West German concern Heyden. Under the agreement Heyden was to supply know-how and data for construction and operation of a plant to manufacture saccharine by the flow sheet process. The assessee had to pay 10,000 DM immediately and a royalty of 2.5% on the sale of the manufactured product subject to a ceiling of 35,000 DM. The Income-tax Officer disallowed the assessee's claim that the payment constituted a royalty which was deductible as a business expenditure. The High Court also held that the assessee acquired ownership of the know-how and data for use by it in future without any time-limit. It was not merely entitled to use it as long as it paid the royalty. The assessee obtained an advantage of enduring nature. The payment was of a capital nature and was not admissible as business expenditure: Ramkumar Phar-

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maceutical Work v. CIT (1979) 119 ITR 33 (Allahabad).

PAYMENT BY NEW ENTERPRISES

The Bombay High Court's decision in the case of CIT v. Tata Engineering and Locomotive Co. Ltd., (Telco) (1980) 123 ITR 533 (Bombay) is a landmark decision in the realm of allowability of payments under collaboration agreements in general and by a new enterprise in particular. It covers some very important issues. Telco had entered into two agreements. Under the first agreement entered into with Daimler Benz of West Germany, Daimler Benz was to provide drawings, designs and full technical information required for manufacture of automative products. Daimler Benz was also to provide training facilities for Indian personnel in its plants in Germany. Telco could also use the trade name of Daimler Benz. The agreement was for 15 years but one of the parties could terminate the agreement by six months' notice in case of a serious breach of its terms and conditions. After the agreement came to an end, Telco was authorized to continue to manufacture but it could not use the trade name of Mercedes Benz. Under the second agreement Henricot, a Belgian firm, agreed to give technical advice, information and assistance to Telco steel foundry and to provide training facilities to Telco personnel at its plants in Belgium. The agreement provided for payment of royalty and percentage of profits for the provision of know-how.

The question that arose in this case was regarding the deduction of know-how fees paid under the collaboration agreements.

The Income-tax Department's case was that the payments made to Daimler Benz were on capital account on several specific grounds. The first was that the expenditure related to the initial setting up of business of manufacture of Daimler Benz trucks, i.e. the advice and technical assistance given by Daimler Benz were in respect of setting up of such new business. A similar plea was also raised by the Income-tax Department in the case of Triveni Engineering Work Ltd. v. CIT (1982) 136 ITR 340 (Delhi) mentioned earlier in another context. In that case too, the Delhi High Court did not consider it relevant whether the fees were paid before the manufacture commenced or whether it was paid to enable the Indian company to start its manufacturing business for the first time. The expenditure was held to be allowable.

USE OF KNOW-HOW AFTER EXPIRY OF AGREEMENT

Another ground which was pressed by the Revenue in the Telco case was that upon the expiry or termination of the agreement, which was for 15 years, the Indian company would have the right to continue in the field of manufacture. The technical information and experience gained by it in terms of the expired agreement remained in its possession and would be available to it after the expiry period. The only bar on it would be that it would not be able to use any trade mark or trade name of the foreign collaborator. According to the Department, these facts rendered the expenditure as one on capital account. The Bombay High Court categorically rejected these arguments. It observed that technical know-how made available by a party to such an agreement does not stand on the same footing as protected rights under a registered patent. There is no property right in know-how which can be transferred as in the case of patent. A party supplying the know-how can hardly take back all the information supplied, after the other party to the agreement has fully equipped itself and made itself familiar with the technical information and know-how supplied. The High Court finally concluded that the fact that production could still be continued after the termination of the agreement was entirely immaterial for deciding whether such know-how can be treated as a capital asset.

PAYMENT BASED ON PRODUCTION

In the Telco case Revenue mounted another attack in respect of allowability of payments made to Henricot on the ground that they were fixed with reference to a percentage of profits. This plea was not accepted by the High Court and the payment was not treated as capital expenditure. Earlier, in the Ciba case (1968) 69 ITR 690 (SC) decided by the Supreme Court, a stipulated payment, dependent upon the sales, was also treated as admissible.

An explicit ruling on this subject is available in the case of Praga Tools Ltd. v. CIT (1980) 123 ITR 773 (Andra Pradesh). The assessee was carrying on the business of manufacture of precision and machine tools, machinery and forgings. It entered into two similar foreign collaboration agreements with a U.K. company for the manufacture of certain machines. The assessee agreed to pay initially £ 1,000. The agreement was for a period of 10 years. It could be renewed for a further period of 5 years by mutual consent. During the period of time to which the agreement applied the assessee had to pay royalties of 5% on the Indian selling price of the production of the machine, subject to Indian taxes. The assessee claimed that the royalty payment made on the production of goods constituted revenue expenditure and was deductible in determining the taxable income. The Income Tax Officer did not accept the assessee's claim. When the question came up before a Full Bench of the Andhra Pradesh High Court, it held that the expenditure incurred had a direct nexus or relation to the carrying on or conduct of the business of the assessee. Such expenditure must be treated as integral part of the profit making process. The very object of the payment of a royalty based upon the production and sale of the products manufactured by the assessee was to obtain a manufacturing licence and technical know-how, including drawings, designs, specifications and other technical information to enable the assessee to man-

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ufacture and sell the products covered by the agreement. The royalty payment was of a revenue nature and was deductible on principles of business expediency.

LUMP-SUM PAYMENT

There are a good number of cases on this subject. It will be sufficient to note one of the more recent cases namely CIT v. Bajaj Electricals Ltd., decided by the Bombay High Court (1984) 148 ITR (Bombay). The Indian company entered into a licence and technical assistance agreement with Westing House Electrical International Company of U.S.A. The agreement was for a period of 10 years. The licence granted was an exclusive licence to manufacture in India certain specified apparatus and material. The technical and manufacturing information was to consist of mainly drawings, process specifications, material specifications, purchasing specifications and test data. At the time of signing of the agreement a lump-sum fee of $ 25,000 was payable for the drawings and specifications and other necessary information prior to the starting of manufacture.

This amount was not allowed by the Income Tax Officer. According to him it was an initial payment made prior to manufacture and related to capital assets like drawings and specifications. When the matter reached the Bombay High Court it held that the lump-sum payment was admissible as revenue expenditure. It was not in relation to any capital asset because there were no property rights in the technical know-how and the assessee did not derive any benefit of enduring nature.

The Court further held that it was irrelevant to consider whether the payment was made prior to the start of manufacture and whether it was in a lump-sum or recurrent payment. Another case reported earlier is the Bombay High Court's decision in the case Kirloskar Co. Ltd. v. CIT (1982) 136 ITR 716 (Bom). This decision was also in the assessee's favour.

EXCLUSIVE RIGHT TO MANUFACTURE AND SALE

The latest reported case of CIT v. Southern Switchgear Ltd. (1984) 148 ITR (Madras) 272 would suffice to give a broad current position of this subject. Where a payment is made under a collaboration agreement to impart technical know-how as well as an exclusive licence to manufacture, the payment will have to be apportioned between the two and the portion relating to acquisition of exclusive right to manufacture will be inadmissible as capital expenditure. The facts in this case were as follows: the assessee company entered into a foreign collaboration agreement. The agreement provided for the supply of technical aid and information for the manufacture and sale of products. Technical assistance also envisaged establishment of a factory. The foreign company undertook not to manufacture the same products in India nor to grant the right to any other person in India. The High Court held that disallowance of 25% of technical aid fees and royalty as capital expenditure was justified on the facts of this case. The assessee, in addition to the acquisition of technical knowledge, obtained an exclusive right to manufacture and sell its articles without any objection from any one including the foreign collaborator. Royalty was also paid for the acquisition of the exclusive privilege of manufacturing and selling its products.

REVENUE V. COURTS

The case law noted in the preceding paragraphs is only illustrative. It is not exhaustive and there are many more cases on this topic. However, starting from the earliest and coming to the latest decision, one broad uniform pattern which clearly emerges is that Courts are more or less unanimous in their thinking that technical know-how fees for manufacturing process supplied by way of drawings, designs, information or otherwise are deductible as revenue expenditure. The different arguments advanced by Revenue for getting them treated as capital outlay have not been accepted by the Courts.

TAX REFORM

It will be seen from the foregoing discussion that there was a constant tug-of-war between the taxpayers and tax authorities on questions of allowance of payments under foreign collaboration agreements. The consequential litigation was expensive and time consuming. Government has belatedly recognized the need to curtail this wasteful exercise and a new Section 35 AB has been introduced in the Income-tax Act by the Finance Act 1985. Any payment of a lump-sum consideration paid by an Indian assessee for acquiring technical know-how for his business is now allowed in six annual instalments commencing from the year in which the payment is made and five succeeding years. To encourage acquisition of technology from indigenous sources, that is, know-how developed in a recognized laboratory, university or institution in India, the deduction is allowed in three equal instalments instead of six laid down for foreign sources.

The Government's approach at tax reform is somewhat limited and does not provide the requisite relief. Government has adopted the amortization approach in the new Section 35 AB by assuming that expenditure incurred on acquisition of technical know-how is capital expenditure and is not normally admissible in computing business income. Sec. 35 AB, therefore, allows amortization over the stipulated number of years. The assumption that payment for technical know-how is capital in nature is not based on sound premises. In recent years the Courts have predominantly taken the view that such expenditure is of revenue nature. The reasoning of the Courts has evolved on the following lines:

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- Technical know-how cannot be considered as an enduring asset. This thinking is based on the well-known fact that technical know-how in the fast developing scientific and technological arena becomes outdated or obsolete within a very short period. Research, development and innovations are constantly progressing year after year.
- Some Courts have adopted a new line of thought. According to them, technical know-how is not only an asset which is not enduring, but also it cannot be treated as a capital asset. Technological know-how is not comparable to some of the popularly known examples of intellectual property such as protected rights under a registered patent. In their view, there are no property rights in technical know-how as distinguished from copyrights, patent rights and trade marks, in which the owner has property rights.

The Courts are continuously following the above approach in cases which are pending before them and which are submitted to them. Two latest instances, where the Courts have allowed the taxpayers claims of deductions wholly in one year are:

1. Addl. CIT v. Buckau Wolf New Engineering Works Ltd. (1984) 150 ITR 180 (Bombay);
2. CIT v. Bharat Earth Movers Ltd., (1985) 155 ITR 321 (Karnataka).

NEED FOR PRAGMATIC APPROACH

The introduction of the new Section 35AB will not bring an end to litigation. Taxpayers will continue to claim the expenditure on payments under foreign collaboration agreements as wholly allowable in one year under Section 37(1) of the I.T. Act. If disallowed by the Income-tax Officer, they will go in appeal where they will get it in most of the cases. It is, therefore, necessary for the Government to take cognizance of the views expressed by the Courts. It should replace Section 35AB by a new section, making provisions to allow 100% of the payments made under approved foreign collaboration agreements in the year of payment itself. This should not be difficult in view of the situation explained in the beginning of this Article. India needs selective foreign technology for its economic growth. The agreements entered into by foreign companies with Indian participants have to conform to the Government's prevailing technology policy. They come into operation only after Government's approval. Such approvals are increasing both in numbers and in terms of value. Payments made under such economically desirable and administratively approved agreements should be allowed in full in the year of payment itself. The amendment should also be made applicable with retrospective effect so that accumulated appeals are disposed of quickly bringing an end to the existing languishing litigation.

Foreign companies negotiating collaboration agreements with their Indian counterparts will be well advised to take into consideration the existing tax travails of the latter. They should fully cooperate with the Indian partners at the time of finalizing the agreement. They should assist the Indian participants by incorporating appropriate language and terms in the agreement so that the Indian parties do not face problems under the present tax laws. This approach is for mutual interest. The tax effect of an agreement is always one of the important factors in the mind of a participant which has to make the payment. The helpful approach of making it smooth for the local participant to meet requirements of its home tax laws will usher in finalization of a greater number of collaboration agreements with expedition. The interest of foreign companies is more predominant because a good number of Indian companies entering into agreements are either subsidiaries or group members of the collaborating foreign companies.

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Taxes and Computers

By Lars-Erik Wenehed

Administrative computer systems are widely used to monitor information which is entered by the user, such as airline reservation programs.

The most common administrative computer system is the accounting system which compiles, calculates and processes different accounting and bookkeeping items.

A new type of administrative computer system is the tax system, which is split into three categories, namely, programs for: preparing tax return declarations; for calculation of national taxes; and, for calculation of international taxes. Moreover, these programs, or at least the first two categories, can be divided into programs for private individuals and corporate legal bodies.

International tax computer systems may be programs which calculate the national tax levied on foreign earnings, such as the extensive system in operation in the U.S.A. for converting foreign earnings into earnings for U.S. tax calculations.

Another type of international tax system comprises those programs which simulate payment transactions between countries in order to arrive at the best route for payment and the best method of payment.

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Using this type of program, it is possible to find the optimum channel for transferring earnings from the country where the earnings were generated to the country where such earnings are to be used in, for instance, investment. This has not hitherto been possible because of the astronomical number of calculations required. By way of example, it might be mentioned that for finding the best route from one country to another within a multinational established in twenty countries, no less than 2,500,000,000,000,000 calculations are required, and 6,000 items of information are needed.

Since it is impossible to execute this number of calculations in traditional tax planning, attempts are generally made to find a solution which results in low taxation in the country where the earnings are generated and low taxation in the country to which the earnings are subsequently transferred. The solution to this problem is often the use of tax havens, which may entail that when the funds are ultimately to be used and are transferred to their final destination, they are subject to punitive rates of tax. Furthermore, it is becoming increasingly common that the fiscal authorities in many countries see through and disregard such moves as payment via tax havens.

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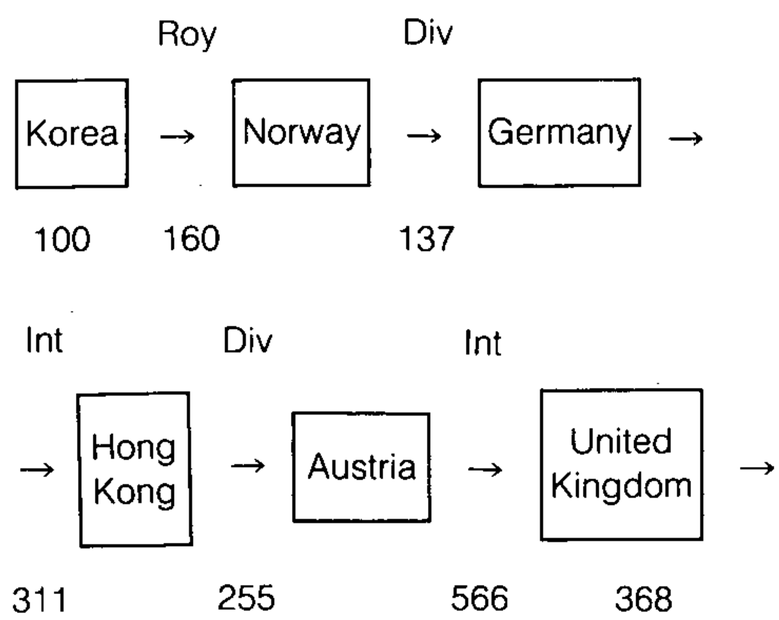
In computer program assisted calculations, payment flows through high taxation countries are often suggested, which may seem surprising. However, the reason for this is that high taxation countries have established an extensive network of double tax treaties. These treaties, combined with the legislation of the countries involved, often grant total tax relief on foreign earnings, such as dividends, or make available large-scale credit for foreign taxes paid. When the amount in question is retransferred, this often takes the form of a deductible expense which reduces the level of taxation in the country of destination. This reduction will, in such an instance, be considerable because of the high rates of tax in that country.

Calculations carried out using the COMPTAX system for finding the optimum route for transferring royalties from Korea (KR) to the United Kingdom (GB), when the multinational is established in Australia (AU), Austria (AT), Belgium (BE), Denmark (DK), Federal Republic of Germany (DE), Hong Kong (HK), the Netherlands (NL), Norway (NO), Sweden (SE) and the U.S.A. (US) give the following result:



The calculation above is made as follows:

The starting figure is 100 (after tax) in Korea. It is assumed that a royalty will be paid, which is deductible as cost. The System then calculates the pre-tax amount which is 178, with a company tax of 43.7%. This is the amount of royalty paid from Korea. From this amount is deducted a withholding tax of 10% or 18, so that the company in Norway will receive 160.

The royalty is taxed in Norway with a company tax of 50.8%. From this tax a credit for withholding tax paid is given. Consequently the tax in Norway will be 73 and the after tax result is 87.

The System assumes that the after tax result in the countries between the first country and the last country is the same after the transaction as before. Consequently the amount paid out of Norway is 87 after tax.

The payment is effected in the form of a dividend and as the company tax on dividends is 23% (compared with 50.8% as normal tax) the after tax amount of 87 is recalculated to a pre-tax amount. This amount is 177 from which is deducted 23% tax so that a dividend of 137 can be distributed.

The dividend is paid to Germany and is not taxed in that country. The after tax result has increased with 137. The interest paid from Germany shall consequently correspond to 137 after tax. Interest is deductible as a cost and 311 corresponds to 137 after tax with a company tax of 56%. This operation assumes of course that there is a taxable income in Germany of at least 311.

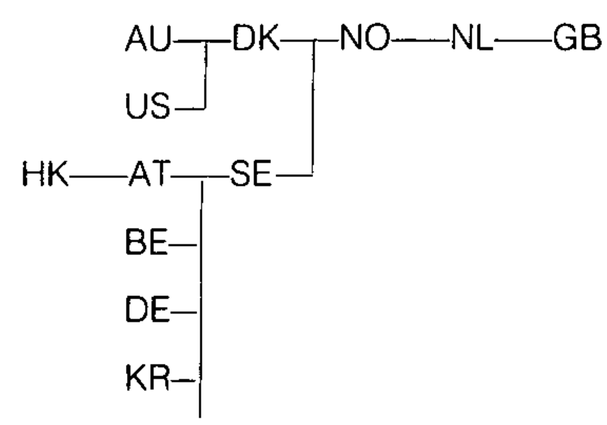
This amount is received in Hong Kong and taxed with 18%. The result after tax is 255 and this amount is paid as a non-deductible dividend.

The dividends are received in Austria tax-free and the interest paid to the U.K. is 566, which corresponds to 255 after tax. The company tax in Austria is 55%. Please bear in mind that for this scheme to operate the taxable income in Austria must be at least 566.

Interest received in the U.K. from Austria is taxed with 35% and the end result is 368. See Exhibit I.

Out of 100 net after tax, which is the initial figure in Korea, there will be obtained 368 net after tax in the United Kingdom. The difference of 268 consists of tax savings in the countries en route. The corresponding figure if a royalty payment is made direct to the United Kingdom is 115. The calculations are made without any restrictions whatever, and can perhaps seem to be unrealistic. Naturally, there must be ulterior commercial reasons for the transactions. These are pre-requisites for the calculation, like other conditions and restrictions valid for the user.

Another possibility with this type of software is to build an optimum ownership structure, which is illustrated by the following example. Note that the same countries as in the preceding example are included, and the parent company is quartered in the United Kingdom:



See Exhibit II.

It is possible to effect this type of tax planning manually, for which reason this mode of approach in tax planning contexts is quite novel, but it will certainly gain in acceptance at the same rate as computers spread to corporate international tax departments.

EXHIBIT I

COMPTAX

CALCULATION PRINT

For Hypothetical

KR REP. OF KOREA

IN		OUT		
Net received	:	Net received	:	
Kind of income	:	Kind of payment	: ROY Patent	
Profit after tax	:	Profit after tax	:	
Loss carried forward	:	Company tax	: 43.7%	
Taxable	:	Comp. tax after credit	:	
Credit of tax	:	Amount available for payment after tax	:	100
WHT previous country	:	Deductible as cost	: 100.0%	
Matching credit	:	Tax savings/ACT/WHT	:	78
Comp. tax pr. country	:	Gross payment out	:	178
Company tax	:	WHT	: 10.0%	(18)
Comp. tax after credit	:	Payment out	:	160
Received after tax	:			

NOTE: REP. OF KOREA
No comment

NO NORWAY

IN		OUT		
Net received	: 160	Net received	:	160
Kind of income	: ROY Patent	Kind of payment	: DIV	
Profit after tax	: Yes	Profit after tax	: Yes	

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Loss carried forward	: No		Company tax	: 23.0%	
Taxable	: 100.0%	160	Comp. tax after credit	:	(23)
Credit of tax	: 1		Amount available for payment after tax	:	136
WHT previous country	: 10.0%		Deductible as cost	: 0.0%	
Matching credit	: 0.0%		Tax savings/ACT/WHT	:	1
Comp. tax pr. country	:		Gross payment out	:	137
Company tax	: 50.8%		WHT	: 0.0%	(0)
Comp. tax after credit	:	(73)	Payment out	:	137
Received after tax	:	87			

NOTE: NORWAY
No comment

DE GERMANY

IN			OUT		
Net received	:	137	Net received	:	137
Kind of income	: DIV		Kind of payment	: INT	
Profit after tax	: Yes		Profit after tax	: Yes	
Loss carried forward	: No		Company tax	: 56.0%	
Taxable	: 0.0%		Comp. tax after credit	:	
Credit of tax	: 0		Amount available for payment after tax	:	137
WHT previous country	:		Deductible as cost	: 100.0%	
Matching credit	:		Tax savings/ACT/WHT	:	174
Comp. tax pr. country	:		Gross payment out	:	311
Company tax	: 56.0%	(0)	WHT	: 0.0%	(0)
Comp. tax after credit	:		Payment out	:	311
Received after tax	:	137			

NOTE: GERMANY
No comment

HK HONG KONG

IN			OUT		
Net received	:	311	Net received	:	311
Kind of income	: INT		Kind of payment	: DIV	
Profit after tax	: Yes		Profit after tax	: Yes	
Loss carried forward	: No		Company tax	: 18.0%	
Taxable	: 100.0%	311	Comp. tax after credit	:	(56)
Credit of tax	: 1		Amount available for payment after tax	:	255
WHT previous country	: 0.0%		Deductible as cost	: 0.0%	
Matching credit	: 0.0%		Tax savings/ACT/WHT	:	0
Comp. tax pr. country	:		Gross payment out	:	255
Company tax	: 18.0%	(0)	WHT	: 0.0%	(0)
Comp. tax after credit	:	(56)	Payment out	:	255
Received after tax	:	255			

NOTE: HONG KONG
No comment

AT AUSTRIA

IN			OUT		
Net received	:	255	Net received	:	255
Kind of income	: DIV		Kind of payment	: INT	
Profit after tax	: Yes		Profit after tax	: Yes	
Loss carried forward	: No		Company tax	: 55.0%	
Taxable	: 0.0%		Comp. tax after credit	:	
Credit of tax	: 0		Amount available for payment after tax	:	255
WHT previous country	:		Deductible as cost	: 100.0%	
Matching credit	:		Tax savings/ACT/WHT	:	311
Comp. tax pr. country	:		Gross payment out		566
Company tax	: 55.0%	(0)	WHT	: 0.0%	(0)
Comp. tax after credit	:		Payment out	:	566
Received after tax	:	255			

NOTE: AUSTRIA
See "Notes" Menu 5:4

GB UNITED KINGDOM

IN			OUT		
Net received	:	566	Net received	:	
Kind of income	: INT		Kind of payment	:	
Profit after tax	: Yes		Profit after tax	:	
Loss carried forward	: No		Company tax	:	
Taxable	: 100.0%	566	Comp. tax after credit	:	
Credit of tax	: 1		Amount available for payment after tax	:	
WHT previous country	: 0.0%		Deductible as cost	:	
Matching credit	:		Tax savings/ACT/WHT	:	
Comp. tax pr. country	:		Gross payment out	:	
Company tax	: 35.0%		WHT	:	(198)
Comp. tax after credit	:	(198)	Payment out	:	368
Received after tax	:	368			

NOTE: UNITED KINGDOM
See Notes Menu 5.4.

EXHIBIT II

COMPTAX

RESULTS
Possible combinations

1.	KR---R--->	NO---D--->	DE---I--->	HK---D--->	AT---I---> GB
	100 160	137	311	255	566 368
2.	KR---R--->	NO---D--->	DE---I--->	HK---D--->	AT---R---> GB
	100 160	137	311	255	510 368
3.	KR---R--->	NO---D--->	NL---R--->	HK---D--->	AT---R---> GB
	100 160	137	236	236	472 341
4.	KR---R--->	NO---D--->	NL---R--->	HK---D--->	AT---I---> GB
	100 160	137	236	236	524 341
5.	KR---R--->	NO---D--->	DE---R--->	HK---D--->	AT---R---> GB
	100 160	137	233	233	466 337
6.	KR---R--->	NO---D--->	DE---R--->	HK---D--->	AT---I---> GB
	100 160	137	233	233	518 337
7.	KR---R--->	NO---D--->	DK---R--->	HK---D--->	AT---R---> GB
	100 160	116	233	233	465 336
8.	KR---R--->	NO---D--->	DK---R--->	HK---D--->	AT---I---> GB
	100 160	116	233	233	517 336
9.	KR---R--->	HK---D--->	AT---I--->	NO---D--->	DE---I---> GB
	100 130	130	288	222	504 328
10.	KR---R--->	HK---D--->	AT---I--->	NO---D--->	DE---R---> GB
	100 130	130	288	222	504 328
11.	KR---R--->	HK---D--->	AT---R--->	NO---D--->	DE---R---> GB
	100 130	130	259	222	504 328
12.	KR---R--->	HK---D--->	AT---R--->	NO---D--->	DE---I---> GB
	100 130	130	259	222	504 328
13.	KR---R--->	DK---R--->	HK---D--->	AT---I--->	BE---I---> GB
	100 160	178	178	395	424 324
14.	KR---R--->	NO---D--->	DE---I--->	HK---D--->	AU---I---> GB
	100 160	137	311	255	450 325
15.	KR---R--->	NO---R--->	HK---D--->	AT---I--->	BE---R---> GB
	100 160	178	178	395	499 324
16.	KR---R--->	NO---R--->	HK---D--->	AT---I--->	BE---I---> GB
	100 160	178	178	395	424 324
17.	KR---R--->	NO---D--->	DE---I--->	HK---D--->	AU---R---> GB
	100 160	137	311	255	450 325
18.	KR---R--->	DK---R--->	HK---D--->	AT---I--->	BE---R---> GB
	100 160	178	178	395	499 324
19.	KR---R--->	SE---R--->	NL---R--->	HK---D--->	AT---R---> GB
	100 160	215	215	215	429 310
20.	KR---R--->	SE---I--->	NO---R--->	HK---D--->	AT---I---> GB
	100 160	215	215	215	477 310

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(B. 107.590)

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XXI CIAT GENERAL ASSEMBLY

The XXI General Assembly of the Inter-American Center of Tax Administrators (CIAT) was held in Ottawa on 4-8 May 1987, with participation of 125 delegates representing 44 countries and 11 international organizations.

The meeting was sponsored by Revenue Canada, Taxation, and the main themes considered were "Taxpayer Assistance, Information and Education" and "Staff Development in the Tax Administration".

Both themes gave delegates the opportunity of discussing practical aspects aimed at improving treasury-taxpayer relationships. These included the problem resolution program being carried out by the U.S. Internal Revenue Service; the public enquiries information bank in Revenue Canada, Taxation; experiences in tax education and staff training in several Latin American and European countries; and, the systems approach to training and the computer based staff training program used by the U.S. Internal Revenue Service. The meeting was developed through plenary sessions, panels and working groups and conclusions were compiled in a report presented by the General Rapporteur, Dr. Sheldon Cohen, former Commissioner of the U.S. Internal Revenue Service. During the Assembly's administrative session, CIAT members approved the 1987-1988 activities plan and budget and elected the new Executive Council, under the chairmanship of the Deputy Minister of Revenue Canada, Taxation, Dr. Harry Rogers. The next CIAT meetings will be held: in Madrid, in October 1987, under the sponsorship of the Secretariat of Finance of Spain to consider "Organization and Functions of a Modern Tax Administration"; and in May 1988, in Brazil, to deal with the topic of "Management, Policy and Cooperative Approaches among Tax Administrations to Discourage Tax Avoidance and Evasion".

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Current Trends in Income Taxation in Eastern Europe

By Prof. Dr. Tibor Nagy

INTRODUCTION

Income taxation has recently moved to the fore in the area of economic policy as both socialist and capitalist countries begin to formulate major tax reforms. In this atmosphere, tax policy is connected with socio-policy too. However, in order to understand the present situation the past must be understood. The underpinnings of our present income tax system date back almost 200 years when taxation was recognized as a means of earning revenue from each person according to capability and a manner in which income could be redistributed. The policy underlying our tax systems has been refined through the method of legal comparison. The researcher must utilize the different parameters and experiences, and the interaction of national laws. The result of proper integration of the world's experience militates toward a uniform income tax concept dominating the economic policy of the industrial countries.

Bernhard Grossfeld has examined the fate of income taxation in his excellent work[1], wherein he recognizes the extent to which Adam Smith's theses of the 18th century on income taxation[2] were adopted. The early introduction of an income tax in England and Prussia has been followed to the point of world-wide acceptance.

The international economic challenge, the effort to modernize, the unfavourable economic climate, have all stimulated socialist countries to rapidly reorganize their national economies and to introduce reforms of the economic mechanism. The linked economic mechanisms being prices, wages, the budget and, of course, taxes.

Income taxation is acquiring a new role in the Eastern European countries as well as in international relations. This report, which is not intended as a rival or substitute for the work of Grossfeld, will identify some of the trends and plans concerning income taxation in order to inform and support an initiative for a more extensive scientific exploration of the subject.

Soviet model as the socialist model

A new age started for income tax in the Eastern Hemisphere when the Soviet Union introduced a new income tax combined with property tax in 1922 serving the purpose of the new economic policy[3]. The property tax character ceased in 1924. This tax had primarily applied the principle of class discrimination. The taxpayers were put into four categories: employed workers, self-employed persons, those receiving income from enterprises, pensioners' and other income classified as unearned or non-labor income. Juridical persons, e.g. joint stock companies, were also included. It is remarkable that at the beginning the socio-political aims dominated, i.e. not the economic political aims. After some years the character of tax had been changed: it became the tax of earners of wages and salaries. Furthermore, persons who had a license for a handicraft service (mostly in the villages) also paid tax. This taxation system was unusually simple from the aspect of tax technique – its revenue was only 3-5% of the budget because the state revenues originated primarily from the turnover tax of the socialist sector.

Professor Dr. Tibor Nagy was born in Budapest in 1924. He obtained a doctorate in politics at the University of Budapest in 1946 and a doctorate in law a year later. In 1949, he became ministerial secretary in the Supreme Economic Council, and in the year after, deputy chief of the financial department in the Ministry of Education. In 1961, he was awarded the scientific degree "candidate" by the Hungarian Academy of Sciences and, in the same year, was appointed associate professor in the Faculty of Law and Political Sciences at Budapest University, where, in 1969, he became professor and head of the Department of Financial Law. In 1983, Professor Nagy became a visiting professor at Hamburg University.

Professor Nagy studied public finance and financial law with research fellowships in the U.S.S.R. (1957), the German Democratic Republic (1959) and Poland (1960). During 1968-1969, he was a Ford Fellow at Harvard and Columbia Universities. He is the author of books and articles on financial law, international financial (tax) law, financial systems and law of the socialist economic integration and the history of Hungarian State finances. Since 1961, he has published 40 works in Hungarian and 43 in other languages.

Professor Nagy is a member of the Institut International de Finances Publiques and the World Association for International Relations.

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2. Smith, Adam, *The Wealth of Nations,* Book V. (1778).
3. Holzman, Franklin D., *Soviet Taxation,* Cambridge, (1955), at 181.

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The agricultural tax has supplemented the state's revenue. This burdened agricultural incomes, from the viewpoint of public finance. The agricultural tax was a property tax, but it could be taken as a yield tax because, regardless of the real income, an estimated average income was considered as the tax base. Payment was based directly on the amount of cultivable land in use by the farmer without regard to the manner in which the land was used or of the extent of livestock holdings.[4] Different rates of tax were applied by regions depending on the fertility of land, availability of markets, irrigation, etc. This system is virtually unchanged with corrections having only been made in the tax rates.[5]

Today there is a "double schedular income tax system" – at least in name. Soviet tax policy further separates the taxation of urban and rural incomes and these taxes are complemented by other supplementary taxes which burden personal income; bachelors and persons with a small family; fees on farm produce markets, etc.[6]

The adaptation of this "socialist" model was required under the socialist economic policies of the European countries in the 50's. These policies suggested the separation of the agricultural sector from the non-agricultural sector for tax purposes – that was one of the characteristic features. But this separation deprived the Budget of revenue from one of its major sources by improperly distributing the burden to unrealistic income in the agriculture sector. (The Hungarian practice differed from this, e.g. in 1949 the general income tax was introduced which burdened every income, including agricultural income, but it was not advantageous for agriculture, reduced the stakes, and gave a possibility for the tax authority to use unjustified high taxation based on estimation. The peasantry was not accustomed to keeping books of account, nor could the tax authority calculate their income correctly. However, from 1956 the income tax on agriculture is once again an independent tax, with rules which are based largely on the same principles as in the Soviet system.)

We have to remember that this "socialist" Soviet income taxation model was endangered by the Khrushchev initiative, which was enacted in 1960.[7] The Soviet Government planned in that year the gradual elimination of income tax[8]. An argument was that income tax produced only a small portion of the revenue for the budget, furthermore there was a sense that income tax worked contrary to the social policy of increasing living standards. However, in practice it became obvious that this personal regulator tax is needed in order to apportion incomes and to maintain fiscal control. This law was repealed in 1962.[9]

The income tax system of COMECON countries

The major influence on COMECON Member States' tax legislation has come from the Soviet socialist model. This is understandable because the Eastern European countries have experienced similar trends – at least until the middle of the 60's.

The addition of the Soviet socialist model has resulted in the formation of a hybrid dual system during the post-war years. The taxes of the old system remain and the tax administration procedure has not been changed substantially although some changes did occur to serve the economic goals of the State (e.g. low tax rates for employees, and allowances and exemptions for the members joining cooperatives).

The Soviet socialist model has brought with it the differentiated tax system: taxation of individuals by the combined application of income taxes, turnover taxes, property taxes, fees considered to be taxes from the viewpoint of public finance, etc.

A global view of the COMECON Member States' tax systems will reveal many similarities with several interesting specific legal and political differences appearing in the modern detailed regulations[10]. These similarities are not the result of a harmonization plan, neither in the sphere of company taxation nor in the sphere of individual taxation. However, the Financial Committee of COMECON has requested that Member States inform each other of any changes in their tax laws. This is a reasonable request in light of the multilateral agreement for the avoidance of double taxation. The frequent mention of a COMECON custom union indicates that some planned harmonization will be needed in the future.

Another area for harmonization occurs within the individual state. The federal system provides for a conflict between the central taxing authority and the member states. In the Soviet Union and Czechoslovakia the central taxing authority imposes all taxes, therefore the tax system is uniform. Yugoslavia has granted the right to tax to each of the 6 Member States. In order to support the national economic plans some harmonization must occur. As a result, the "Agreement on Harmonizing the Tax System" with the purpose of providing unity and stability in the market through harmonization of the separate tax systems was signed in 1984. A constitutional change is expected which will place the taxing power in the hands of the central government.

A comparative overview of the various tax systems will be used in this article to elucidate the characteristics of income taxation rather than individual surveys of each country. The most important point to remember within the framework of the COMECON

4. Holzman, at 189.
5. Nagy, Tibor, "USSR: the 1984 Budget Act and the Tax System", *Bulletin for International Fiscal Documentation* (1984), at 311-315 and 450.
6. The history and all legal problems of Soviet taxation are discussed in detail by: Janus, Hans, *Steuerrecht und internationales Steuerrecht der Sowjetunion*, Frankfurt am Main (1987).
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8. Wessely, Antal, *A lakosság egyes adóinak fokozatos megszüntetése a Szovjetunióban*, Pénzügy és Számvitel (1961), at 256-258.
9. Kolms, Heinz, *Finanzwissenschaft*, Band III, Berlin (1976), at 28-30.
10. See *Guides to European Taxation, Vol. V: Taxation in European Socialist Countries*, International Bureau of Fiscal Documentation. Amsterdam (1981). Completed with 10 Supplements.

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countries is that there is not just one income tax, but there are several income tax schedules (the agricultural tax is one of the schedules). The various taxes are not combined, i.e. there is no aggregated taxation. This allows the stimulation of various practices under the different categories. The Soviet Union, having a complex income tax system, has 4 tax rate categories and Romania has 6. Hungary applies the "general income tax" schedule (2-65%) to all income which is not covered by the pension fee and for which there is no special exemption.

Due to the high priority of state owned property in socialist countries, the vast majority of employees work for state or cooperative institutions. Income tax revenue comes from the salaries of workers and employees and other wage-like income (bonuses, allowances, etc.). Hungary, Romania and Poland are exceptions because wages of employees are exempted (caveat: Poland taxes wages above a certain amount). When income tax is imposed it tends to be lower than in Western countries, e.g. the Soviet Union has a maximum 13%, GDR and Czechoslovakia 20%.

There is a separate tax on handicraft activities performed privately by individuals. The existence of this tax has legalized handicraft activities that are in addition to wage-earning employment. This tax provides an incentive for private initiative through the legalization while also supplying a means for administrative control.

As a further incentive for innovation of a technical nature, almost every country has favorable schemes for investment and depreciation allowances – as appear in the West. These incentives are known to shift the income tax and turnover tax burden to the costumer, specifically, those persons requiring the services.

Other standard means of supplementing income tax revenue are: the bachelor and persons with small families tax (Romania, Bulgaria, the Soviet Union – it existed in Hungary, but has since been repealed), and the tax on men who do not perform military service (Bulgaria and Hungary).

The pension fee

As in most countries of the world, social insurance contributions are required of either or both the employee and the employer in European socialist countries.

In Hungary, where wages are not burdened by an income tax, a pension fee is charged. This is a tax on gross wages.[11] The pension fee is a tax at a progressive rate between 3-15%, without an exemption or a tax allowance, on all wages. For each identical income, only one tax will apply (e.g. general income tax, pension fee or agricultural tax). This excludes the risk of double or multiple taxation. (Double and multiple taxation will be dealt with further in the subchapter dealing with the tax reform.)

Taxation of aliens

Aliens are taxed depending upon their status as: (a) permanent resident or (b) temporary resident employed by a foreign firm or joint venture. An alien is a foreign physical person, as defined in the Decree of 12 May 1978 of the Soviet Union, who is a citizen of a foreign state, irrespective of residence or customary place of abode.

In many cases the Minister of Finance or other authorized person has the discretion to grant tax allowances and/or exemptions to aliens employed by a foreign enterprise or a joint venture. Czechoslovakia grants such tax advantages to employees of joint ventures. Poland exempts income of aliens related to direct economic activities. The GDR has no special rules for foreigners.

Naturally, foreign investors prefer to invest where tax conditions are most favorable and this is taken into consideration.

Soviet income tax reform concepts

Reform of the economic mechanisms is a constant subject of discussion in Soviet literature. A decision was made at the XXVIIth Congress of the Soviet Communist Party to gradually introduce reform in different spheres of the national economy.

The enterprise (company) laws have been a primary area of focus for reform. The basic plan is to reduce state intervention. The shortage of goods has strained the framework of the economy resulting in the appearance of a second and a third economy.

In response to these shortcomings the government has decided to support the profit motive. Enterprises will pay a tax on profits in addition to the turnover tax and will have only a few obligatory planning targets. The previous system of subsidizing an enterprise out of the general budget when costs exceed the sales price is to be replaced. Prices will more closely reflect the actual cost under the profit motive system.

The original dream of a socialist system wherein goods are free of charge and no salaries or wages exist has not been realized. This original aversion to wages and salaries has been a major reason why wages and salaries have remained relatively low. The new economic policy will provide relief in this area.

The new law of 1 May 1987 legalizing individual and joint small enterprises provides the basis for growth in production under the profit motive system. The recognition by the government that state industries have been unable to provide services and goods requested by the population has resulted in a decision to allow individual initiative to satisfy such demands.[12] A recent publication by the government indicates that there are

11. Nagy, Tibor, "Hungarian Social Insurance Contributions as State Taxes", *Legal Development and Comparative Law*, Ed.: Zoltán Péteri, Budapest (1986), at 299-330.
12. *Figyelő*, 1 January 1987.

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29 activities permitted to the individual for which the individual will be subject to Soviet income tax at a rate of 13%.[13] This rate is subject to change depending upon the amount of income received from a specific activity and the importance of that activity to the economic plans as determined by the State.

The importance of this reform should not be underestimated. Studies indicate that nearly 2 million people are involved in such private work without permission, producing 14-16 billion rubles of profit per year.[14] The office for Soviet economic policy forecasts that nearly 4 million people will request a private services work permit. The reward being the possibility of doubling the average monthly income of wages earned from state owned enterprises.

Further reform is contemplated in the area of personal income tax – it is to be replaced by a family income tax[15] wherein the per capita income in the family would be the tax base with incomes under a certain amount exempted.[16] This family income tax will better reflect the social-political plans of the State than the recent individual income tax system, because it allows the 30% tax allowance only in the case of families with more than 4 dependent persons while granting an individual tax-free minimum of 70 rubles per month.

The ineffectiveness of the regulation of 1953 concerning the taxation of household plots has fueled debates for reform.[17] There is a need to encourage the production of foodstuffs on these plots and to limit the illegal profiteering. Producers near main highways and major cities are earning more money from their private plot of land than from their activities for the state agricultural enterprises. However, plots of land located further from these centers of commerce are being used less productively and with decreased interest. The plan to promote production involves the development of a cadastre for the plots and link taxation to the type of producer and the market where the produce is sold (e.g. flowers and fruits will be taxed at higher rates and sales to state agriculture and wholesale organizations will be taxed at lower rates). The progressive fee on farm markets will be increased to provide a more even distribution of the tax burden.[18]

Of interest is the lack of discussion concerning the tax on bachelors and persons with a small family which is a social-political law used to support facilities for children.

In summation, the tax reforms plans far exceed the scope of the reforms of 1930 or 1953 and will have a tremendous impact on private enterprise, family income and agricultural income.

Hungarian tax concepts

In one dramatic movement on 1 January 1968 the Hungarian government introduced a new system of economic management and control. Under the new system objective market factors (e.g. money, price, profit margins, etc.) play a more prominent role. These factors are manipulated by means of complicated tax laws covering wages, salaries, exchange rates, credit and investment policies, foreign trade operations and enterprise assets. These tax laws are tempered by the need for elasticity in the regulations which will facilitate adaptation to each new Five-Year Plan.[19] One of the first reforms to flow out of the actions of 1968 has been the decision to tax enterprises and co-operative organizations the same. Many new taxes have been introduced as well (25 kinds of taxes on legal entities exist in the agrarian and non-agrarian sectors).

Twenty years after the first great reform, in 1988, a new series of reforms will become effective. The two major areas of change will be in the enterprise tax and the personal income tax sectors.[20] The introduction of VAT will result in the discontinuance of several enterprise taxes. The VAT will alter the relation between production prices and consumer prices (the details of the Hungarian VAT plan are discussed in Dr. Lukács' article).

Historically, enterprises have paid various taxes related to wages leaving the employee to pay only a pension fee on wages. Income derived from other sources was taxed separately. From 1986 the various sources of income will be aggregated and taxed as one sum. Certain significant items will not be aggregated, e.g. income from the sale of real estate, income from inventions and income from abroad.

The tax on wages of the enterprise (10%) will be abolished. It was calculated on wages, but it proved to be a burden on the interest base.

The social security tax (40% on enterprises, 33% on agricultural enterprises) will eventually be reduced. It is the intention of the reform plan to tax the final stages of the economic process: the enterprise pay turnover tax (VAT) and the population pays personal income tax on all income.[21] The personal income of the average worker will be increased because of the elimination of various taxes at the enterprise level.

13. *Népszabadság*, 20 November 1986.
14. *Esti Hirlap*, 6 April 1987.
15. *Heti Világgazdaság*, 21 March 1987.
16. *Les Nouvelles de Moscou*, 1 March 1987.
17. *Economitseski Nauki*, No. 5. of 1986, and *Heti Világgazdaság*, 13 August 1986.
18. Janus, Hans, "Die Kolchosmarktgebühr in der Sowjetunion", *Die wichtigsten Gesetzgebungsakte in den Ländern Ost-Südeuropas und in den ostasiatischen Volksdemokratien*, Monatshefte für Osteuropäisches Recht, Hamburg (1981), at 371-372.
19. Nagy, Tibor, "Tax Law Functions in the Enterprise Sphere in Hungary, *The Legal Structure of the Enterprise*, Ed., F. Mádl, Budapest (1985), 295.
20. *Világgazdaság*, 1 March 1987.
21. The reform plans are based on the HSWP's resolution. During its session of 19 and 20 November 1986, the Central Committee of the Hungarian Socialist Workers' Party has adopted a resolution calling for the preparation of a comprehensive reform of State enterprise and personal income taxation, to be effective as of 1 January 1988. The new system of State enterprise taxation should be considerably simplified, but it should also take into account the independence of State enterprise as well as the required "centralization of income". The new personal income tax should be based on the principle of a "just, general and proportionate sharing of taxation", but it should not result in a decrease of net wages and salaries (see *Tax News Service* (1987), at 26).

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The arguments for and against the introduction of a personal income tax continue to rage and a great deal of literature is being produced. The final political decision shall be made soon and the draft of the bill will be discussed by Parliament in September. In recent years unequal effects and differentiations between various social strata has resulted in the enrichment of some taxpayers and the impoverishment of others.[22] Public opinion polls indicate that the Hungarian people want reform to be a more egalitarian distribution of income.[23] In response to this demand the personal income tax is being introduced. This new tax should alleviate many of the problems that have been developing, however, it will not answer them all.

The personal income tax is designed to have a uniform progressive tax burden on all income sources and this, it is hoped, will eliminate – at least in part – differences in consumption resulting from the diversified regulation of income sources. This indicates the supplementary effect of this tax to regulate outgoing purchasing power. The personal income tax will also result in a more fair distribution of the tax burden to individuals with greater ability to pay through its progressive rates.[24]

Statistics are, of course, imprecise, but studies indicate that anywhere from 30-60% of the population has income from a source other than their primary job, social insurance allowance, pension, etc.[25] A second and even a third economy have appeared wherein income from illegal undertakings, tips and other income evade taxation.[26] It is this income the personal income tax will attempt to reach.

The Soviet Union's so-called family income tax has not been supported in Hungary. It will be discussed further before it is included or excluded from future reform proposals. The Hungarian system will not use family status, e.g. married having dependents, as a gauge for tax benefits, but family allowances will be raised generally.

The retention of the pension fee on income from wages or salaries as a revenue source for social insurance should be supported. However, for purposes of applying the personal income, the base salary or wage from the main job of the taxpayer should be subject to a uniform tax rate. All other income should be accumulated and taxed separately. It appears that after 1987 the flat rate pension fee and the flat rate social insurance contribution will function parallel with each other. A tax-free minimum should also be determined above which all income shall be subject to tax ranging from 20-60%.[27]

Exemption of income from tax will be limited to social insurance benefits, allowances, scholarships and other specified social, cultural or political activities.

Different sources of income (e.g. inventions, royalties, artists' honoraria) shall be assessed differently. A different tax base will be developed so that the net of income is taxed consistent with the public finance nature of income taxation. In order for this to succeed, costs and expenditures must be acknowledged in the new regulation.

Associations of citizens, e.g. economic working associations, which are not legal entities, play an important role in the Hungarian economy. These private undertakings may employ a labor force and apprentices – this is the main difference when compared with the new Soviet system. The income of these associations are subject to company tax; the dividends of members are burdened by general income tax and in the future dividends will be subject to personal income tax.

As taxes are better coordinated, the company tax will become a new "tax on undertakings".

There are almost 1 million taxpayers deriving income from agricultural activities in Hungary. Presently, the tax on household and auxiliary plots represents tax on the proceeds of the land, and the agricultural machines and horses used on household plots. This 4 schedule tax should be reformed. An exemption for income used to provide the agricultural needs of the household may be granted. Agricultural production intended for the market should be subject to a special tax. In the beginning this could be a separate schedule in the personal income tax and later it can become a part of the "tax on undertakings".

The general income tax system remains applicable to the end of 1987 (See *Guides to European Taxation, Taxation in European Socialist Countries,* Chapter Hungary, Sec. 8.5.2., for a complete discussion of the topic). Beginning in 1988 the new personal income tax covering some 4 million taxpayers will be instituted. The experience of the West will be helpful in Hungary's attempt to include income from the third economy. This will mean the application of the West's techniques for objective tax assessment on all income, detection of tax avoidance and continuous up-dating of property values. The computer registration system already in use will be a good starting point.

The public has already been informed of these reform plans, but even greater efforts must be made in order for the new system to be understood and accepted.

Some problems still need to be considered. From an economic standpoint: will the personal income tax on essentially the same net wages discourage workers? It

22. Ferge, Zsuzsa, *Gondolatok a személyi jövedelemadóról* (Reflections on the personal income tax), Gazdaság (1986), No.4, at 81-94.
23. Musgrave explained that in the socialist system the strong wage differences need an effective income taxation. (Kolms, op.cit. Vol. I. at 23), Musgrave, R.A., *Fiscal System,* New Haven (1969) and *Finanztheorie,* Tübingen (1969).
24. Falusné, Szikra Katalin, *Az elsó és második gazdaság közötti bér, illetve jövedelemsdiszparitás* (The wage and income disparities between the first and the second economies) Közgazdasági Szemle, (1986), No. 3.
25. Rák, György, *A személyi jövedelemadó bevezetésének lehetóséfei és korlátai* (Chances for and limits to the introduction of a personal income tax), Gazdaság (1986), No. 4, and *Heti Világgazdaság,* 6 December 1986.
26. Falusné, Szikra Katalin, *A magas személyi jövedelmekröl* (On the high' personal incomes) Közgazdasági Szemle (1979), No. 10. Földes, Gábor, *A láthatatlan jövedelmek adóztatásának gazdasági és jogi összefüggései* (The economic and legal aspects of the taxation of invisible incomes), Társadalmi Szemle (1986), No. 8-9.
27. *Heti Világgazdaság,* 6 December 1986.

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will result in increased labor costs. How can the administrative costs of the new system be recovered without unduly burdening the workers? There is consideration of rigid regulation of wages, however, this may result in stimulating the shadow economy.

From a social standpoint, many tax specialists feel that this new law will increase, rather than decrease, inequalities and raise tensions while providing greater opportunities for corruption due to the complexity. The tax cannot be expected to provide democratization and it may turn people against the state.

Encompassing these socio-political decisions is the question of who should pay for common social burdens, the individual or the enterprise? It is arguable that these costs should be borne by enterprises.[28]

Taxation of Hungarian joint ventures and employees

With the 1968 reform came many new legal forms for foreign participation as well. Licenses are bought and sold, and know-how agreements are negotiated. Several hundred cooperation agreements exist between Hungarian and foreign companies, and over one hundred companies are operating abroad with Hungarian participation. These economic associations with foreign participation represent an advantageous form of economic cooperation based on mutual interest.

In 1972 the Hungarian government officially welcomed joint ventures. Joint ventures have been permitted to become established in customs-free zones since 1982.[29] The terms under which joint ventures operate have been simplified several times in recent years. It is now possible to form a joint venture in one step (license, approval, incorporation, registration). As of October 1986 69 joint ventures were active in Hungary.[30] Joint ventures are considered beneficial whether they are service oriented or manufacturing if they aid in the development of technical skills, increase the economic product, enlarge the market system or increase exports. Generally, a foreign partner's share may not exceed 49% but the Minister of Finance may grant exceptions.

A comparison of joint venture requirements in Hungary with those of other COMECON countries will bring to light several differences. Among these differences are percentage of ownership, ease of formation and activities permitted. The Hungarian joint venture may take almost any form (e.g. limited partnership, public limited company).

Joint ventures, after the deduction of the social insurance contribution, are subject to only the corporate tax of 40% of taxable profit. (Production companies and companies operating jointly erected hotels pay a corporation tax of 20% in the first 5 years and 30% thereafter – provided the capital exceeds 25 million forints and the foreign share is 30% or greater. If the joint venture reinvests 50% of the profit, but not less than 5 million forints, 50% of the paid-in tax is refunded; if the reinvestment is 100% or at least 10 million forints, then 75% of paid-in tax is refunded.) Joint ventures operating in priority sectors are fully tax exempt for 5 years and pay a tax of 20% thereafter. Lists of important activities are published by the National Planning Office, the Ministry of Finance, and the Ministry of Foreign Trade. One other point of interest is the full tax exemption of dividends to partners.

Foreign employees are treated advantageously as well. Wages of employees are governed by the Memorandum of Association and the contracts of employment, as stipulated by the statutory rules. The foreign employees receive higher wages than the Hungarian employees as a result of the exchange ratio for hard currencies. The foreign employee receives a wage comparable to their home country's wages, calculated in forints, of which 50% may be repatriated. For social insurance purposes, foreign employees shall be regarded as employees of an alien employer on the territory of the Hungarian State.

Foreign employees will qualify as individuals domiciled permanently abroad with a residence in Hungary for the purpose of carrying out work for the Association. No social insurance contribution is paid for foreign employees. However, special contracts may be concluded to provide health insurance.

Foreign employees of alien enterprises and joint ventures are subject to general income tax on 72% of their wages. In other words 28% of their wage is exempt. Moreover, travelling costs incurred for business purposes and apartment rental fees are not included in the tax base. Deductions are granted for up to 10,000 forints per month if total income minus travel expenses does not exceed 500,000 forints per year; 20,000 forints per month if total income minus travel expenses is more than 500,000 forints and less than 1,000,000 forints per year; and 30,000 forints per month if total income minus travel expenses is more than 1,000,000 forints per year.

The Hungarian statutory rules apply to the customs-free zones for wages and labor contracts unless the Memorandum of Association and the labor contract state otherwise. In customs-free zones Hungarian employees may be paid supplementary wages over and above the salary fixed for their job category. Such supplementary wages are exempt from social insurance contribution and pension fee, but are liable for the general income tax.

While foreign employees will become subject to the personal income tax in 1988, they will still enjoy the tax base allowances of pre-1988. The Minister of Finance should be authorized to regulate these tax relations with special reference to the agreements for the avoidance of double taxation and the mutual interests of the partners.

28. Ferge, op.cit., at 94.
29. Nagy, Tibor, "Taxation of joint ventures in customs-free territories", *European Taxation* (1984), No. 9.
Bán, Chrysta, "Erweiterte Möglichkeiten für ausländische Investitionen in Ungarische Gemischte Gesellschaften in Zollfrei-Zonen", *Recht der internationalen Wirtschaft*, Heidelberg (1986), No. 6.
30. *Daily News* (Budapest), 9 October 1986.

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APPENDIX

The Hungarian tax system (1987)

I. Taxation of citizens

Subject matter	*Tax*
A. Wages	Pension fee
B. Income	1. General income tax 2. Tax on household plots and auxiliary farms
C. Property	1. House tax 2. Tax on buildings not for dwelling purposes 3. Tax on plots 4. Motor vehicle tax
D. Turnover	1. Turnover tax 2. Cultural charge 3. Wine turnover tax
E. State monopolies (Regies)	1. Alcohol tax 2. Tobacco tax
F. Animal keeping	1. Horse tax included in tax B.2 2. Dog tax
G. Male citizens	National defense contribution
H. Local	1. Settlement development contribution 2. Holiday resort charge

II. Taxation of legal entities

The main taxpaying entities can be grouped according to the general economic and financial policies into the following categories:

Group	*Type of entity*
A.	State enterprises Groups of enterprises Economic associations
B.	Agricultural enterprises, state farms, agricultural cooperatives
C.	Foreign companies
D.	Companies with a foreign holding
E.	Economic association with a foreign participation
F.	Other Hungarian legal entities Small undertakings which are not legal entities State banks
G.	Special banking institutions

The following table indicates the obligatory payments which these legal entities are required to make to the State budget.

Taxpayer categories	*Subject taxpayer groups*							
	A	B	C	D	E	F	G	H
1. Social insurance fee	X	X	X	X	X	X	X	X
2. Consumption turnover tax	X	X	X	X	X			
3. Consumption tax	X	X	X	X	X		X	
4. Import turnover tax	X	X	X	X	X			
5. Extra enterprise tax	X	X						
6. Profits tax	X						X	X
7. Salary tax	X						X	X
8. Property tax	X							
9. Accumulation tax	X	X						X
10. Town and village contribution	X	X		X				
11. Production tax	X	X		X	X			
12. Trade tax	X			X				
13. Difference production turnover tax	X	X		X	X			
14. Charge on real estate	X							
15. Charge on acquisition of plots	X							
16. Central technical development contribution	X	X						
17. Land tax	X	X						
18. Income tax – agricultural sector		X						
19. Wage tax – agricultural sector		X						
20. Profits sharing tax		X						
21. Salary tax – agricultural sector		X						
22. Tax on small consumer service enterprises and cooperatives	X							
23. Cultural charge	X					X		
24. Company tax						X		
25. Motor vehicle tax			X	X	X	X		
26. Charge on trucks	X	X					X	X
27. Charge on omnibuses	X	X					X	X
28. Corporation tax			X	X	X			
29. Special corporation tax				X	X			
30. Wage tax	X							X
31. Tax on buildings not used for dwelling purposes			X	X		X		
32. House tax						X		

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HUNGARY:

The Introduction of VAT in 1988*

By József Lukács

József Lukács was born in Beekeescsaba, Hungary. He obtained a degree in economics at the University of Budapest in 1966. In 1968, he became Ministerial Secretary of the Economic Department, and Chief of Section for the Department of Prices and Turnover Taxes in the Ministry of Finance in 1976. In the period between 1979-1985, he was Deputy Director of the International Department in the Ministry of Domestic Trade. Since 1985 he has been Director of the Department of Indirect Taxes (formerly that of "Prices and Turnover Taxes") in the Ministry of Finance.

Recently, the need for substantial change in the conditions under which the Hungarian economy operates has been increasing. This is to a large extent caused by unfavourable processes in the workings of this economy. It is clear that the economic environment for enterprises and the regulations affecting them have to be changed in such a manner that the driving force behind their development is the making of profit. The same driving force should also determine the distribution of goods and services over the various sectors of the economy. In other words, the profit motive should become a recognized goal, second only to regulated market effects decided upon by the Government.

In order to achieve this goal, several conditions are to be met, including a reduction in the redistributive role of the State Budget in addition to reinforcing the importance of markets; greater priority to monetary control instead of the tax policy in controlling purchasing power; and, a type of State intervention which is different from what Hungary has today.

Since 1968, Hungary's economy has been managed by indirect instruments instead of centrally imposed commands. But, despite all the changes and refinements in the system, the major instruments still are taxation and fiscal policy. This implies that certain tasks such as the control of purchasing power are carried out through taxation policy and budgetary redistribution measures which make it impossible for Government control to be stable and predictable. The economic decisions of enterprises failed to be determined by commercial risk; to a considerable extent it was the volume of wages and the Government's control over investments at the corporate level which were dominant. Eventually, a conflict developed between the Government, resorting to excessive centralization and ever increasing redistribution of goods and services, and the various sectors of the economy which were affected differently in this process of centralization and redistribution.

This conflict surfaced even more openly as a result of the process designed to reinforce corporate independence, which began in 1984-85.

The greater independence of corporate management from the central-controlling agencies (i.e. corporate managers are elected by corporate councils under an application system, instead of being nominated by the central agencies) and the break-up of the large monopolistic organizations (which, in most of the cases, were intermediate steps to central control instead of being the products of economic rationality) led to a more open and more forceful expression of diverse interests. The bankruptcy law passed last year was the first serious step towards changing the relationship between economic units by passing some of the, or the entire, risk involved in an unsuccessful operation of a business unit to its partners which was hitherto borne solely by the Government. The year 1987 heralded a new round of changes in the process which brought good results, but was laden with fiascos as well, as it was in 1987 that the functions of the central bank were separated organizationally from commercial banking functions and the conditions for monetary control in the economy were established by founding approximately 20 commercial banks, of which 5 are of national importance. Presently, we do not have an efficient and thoroughly ingrained monetary system.

The mere emergence of the conditions of monetary control and the changes in the conditions of corporate interest call for a review of the relationship between the fiscal sphere and a certain optimization of the profit mechanism affecting the economy. At the same time, as our experiences have also shown, fiscal control resulted in growing distortion of the economic practices and the forms used. It was the realization of these distortions which eventually triggered the process outlined above. As a result of the measures within the pricing and taxation system aimed at improving our external balance of payments and protecting internal price levels, withdrawals from corporate profits rose to such levels and led to such differentiations that they endangered incentives to efficient business activities.

Increased tax burdens imposed on profitable sectors, on the one hand, and the granting of subsidies and exemptions to ailing sectors, on the other hand, re-

* See for a survey of the Hungarian taxation system *Guides to European Taxation: Vol. V, Taxation in European Socialist Countries*, published by the International Bureau of Fiscal Documentation.

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sulted in distortions in producer prices and the unjustifiable expansion of the redistributing role of the State Budget. But boosting the performance of the economy is unimaginable without reinforcing the profit motive of enterprises and a more direct influence of market forces. In addition to certain other factors (including institutional conditions, flexible forms of capital reallocation and monetary control aimed at achieving equilibrium), the development of market forces requires thorough changes in the price structure, its wage content and taxation.

In a nutshell, these are the causes which lead to the realization that a tax reform was needed.

The objective of the price and tax reform is to diminish the tax burden on the business sector, to make it more uniform, and to simplify taxation and budgetary relationships. While reducing the portion of corporate incomes to be contributed to the State Budget and standardizing taxes on profits, the turnover taxes and the taxes to be paid directly by the individual taxpayers will increase without any substantial changes in the real value of the net incomes of these taxpayers and enterprises at the macro level. By eliminating part of the taxes payable from corporate income, the level of producer prices may fall, with some other portion of taxes being transformed into wage cost. This is going to be ensured by introducing value added tax (VAT) and personal income tax (PIT), parallel with modifying the taxation of the business sector and the system of producer prices.

As regards the real value of incomes earmarked for consumption and investment and the new ratios of producer and consumer prices, it would be an identical solution to the one chosen if VAT and PIT would be introduced and the differentiated taxation of production would be standardized in an environment of upward moving prices. The solution chosen, i.e.: income readjustment and changes in the taxation system with falling producer price levels and a limited rise in consumer prices, is supported in part by technical arguments (because not all the parameters of the current system have to be changed) and by a natural anti-inflationary effect. (With a single strong inflationary kick, the combined effects of changes in price ratios and personal income tax would be frowned at even by those strata of society where the real value of incomes took a clearly positive turn.)

As a result of the above measures, the current system of taxation, incorporating many kinds of taxes and highly differentiated tax rates, will be replaced by a simple system, made up of some elements only. In the new system, taxes on profits will fall perceivably and producer and consumer price ratios will be adjusted in line with actual ratios of expenses. It is to be specifically emphasized that the standardization of the tax system will mean a more even tax burden not only for the socialist entities of the economy, including State-owned enterprises and co-operatives. It will affect various kinds of private entrepreneurs as well.

So, the planned tax reform will comprise three elements: the radical change of the enterprise taxes and the introduction of the value added tax and the personal income tax.

In the new corporate tax system, the dominant element is going to be a profit tax at a flat 40% rate in general, instead of the current flat rate profit tax composed of a 15% municipal tax and a 40% profit tax (the profit tax may be lower than 40% in a number of cases.

Withdrawals from profits, proportionate to assets, will be abolished.

As regards the accumulation tax on new investments (which is a substitute for the lack of monetary purchasing power control), its role still needs further analysis. In order to reinforce profit-orientation and to increase the enterprises' freedom in decision making, the elimination of the accumulation tax would be justified. However, this can happen only if the monetary controls are found to replace fiscal instruments in controlling accumulated purchasing power.

Wage tax, payable from after-tax profits, designed to control wage increases at the corporate level, is also going to be reduced considerably. Currently, wages can be increased only if profits allow for paying the taxes. It is justified, however, that the current role of the wage tax is reduced since it exerts a strong influence on profits, subsidies and other taxes. Its complete elimination is subject to the results of the work done with a view to the complete transformation of income regulation.

In the personal income tax system, all Hungarian citizens will have to pay tax on their aggregated income (over a certain threshold of exemption) irrespective of the source of their incomes. At present, incomes are taxed separately and with varying rates depending on the source, if they are taxable at all. By introducing a global personal income tax, there will be a clear distinction between the taxpayers' total income and their effective disposable income. The progressive tax system with its rate brackets will facilitate more equitable, general and proportionate sharing of the tax burden by imposing a relatively higher tax on taxpayers with higher incomes. When introducing this new personal income tax, the sum of the taxes payable by employees receiving wages and salaries will have to be incorporated into their receipts so that their net earnings will remain the same at the start. This assumes appropriate increases in gross wages (i.e. wages will be redefined in gross terms). In line with a certain methodology, the Government will allow for enterprises to do this up to a specified limit without any tax consequences whatsoever, but no corresponding gross wage adjustment is guaranteed for individuals. Consequently, the redefinition of wages in gross terms is not obligatory for the companies either on an individual basis or for all of their employees; it will be subject to bargaining between the companies and the trade unions.

As the tax reform and the modification of the tax system in itself does not allow for expanding the investment opportunities of the economy, the reduction in taxes, payable from profits, should be accompanied by

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a reduction in profits in producer prices and a fall in the actual producer price level.

The problem in the Hungarian economy is not the insufficiency of the propensity to save, due to high taxes imposed on producers. On the contrary, excessive demand is the characteristic factor. This excessive demand is limited in all areas by applying generally high tax rates and imposing special taxes on investments where the necessary resources are generated through prices. Where the prices do not guarantee sufficient resources (in the raw material, energy, productive infrastructure and agricultural sectors, in general), the Government uses tax exemptions, subsidies and taxes together to control the generation of such resources. The excessive demand arises from the disparity between resources generated and resources available, and the reallocation of resources by the Government which are devoid of any entrepreneurial risk. While maintaining the constraints of a balanced supply and demand, the price and tax reform is designed to change the allocation of initial incomes, so that net incomes, supplemented by the various opportunities offered by the lending sector and capital reallocation, would give rise to saving with a structure and extent appropriate for a balanced development of the economy. To put it differently, no excess resources can be generated as the result of taxes, deductions, tax exemptions and subsidies, whereas the ratio by which initial incomes are distributed between the Government and society is bound to change in the initial stage. This is going to be ensured via the fall in producer prices going hand in hand with tax deductions.

Producer prices for energy and raw materials are adapted to world market prices so that their levels are independent from tax payments. As regards prices of finished products, representing large volumes, agricultural purchase prices, transport tariffs and water tariffs, they are centrally planned, the justified price reductions can be enforced and price increases can be kept under control. As to the commodities in the free price category, where corporate price calculations are influenced by indirect means, such as the processing industry, the construction industry, services and the free market commodities, the pricing authorities will ensure appropriate reductions in producer price levels by specifying the pricing regulations required for changing over to the new tax system and by providing guidelines for the calculation and control of the new producer prices.

Perhaps, this will be the most difficult thing to achieve as we will have to re-interpret direct taxes as against other countries where value added tax had already been introduced and commodity taxes had to be transformed into other types of taxes. In Hungary, there is no directly measurable rate of price reduction at the level of enterprises.

The reduction in producer price levels, facilitated by the elimination of taxes, in essence does not affect the raw material and the energy sectors, due to the current inequalities of taxation and the adaptation to world market prices. They do not affect the productive infrastructure whereas agriculture is affected to the extent of the balance of secondary industrial cost reductions and incremental burdens arising from the new corporate tax system. Most of the price level reduction is concentrated in the processing industry. That way, Hungary's producer price ratios will get much closer to the price relations of convertible foreign trade. The elimination of producer taxes will result in differences of output, producer prices reflecting real cost relations, and tax burdens which are still high compared to the level of development. This taxation technique is not contrary to international practices, and it makes comparative advantages more easily measurable, thereby providing a better yardstick to be used in foreign trade relations, sales and development decisions both by the economic policymakers and by corporate management.

The planned modification of the pricing and taxation system constitutes an integral part of the process aimed at developing the price and monetary relations. In this sense, it will contribute towards greater efficiency in management and a faster development of the more profitable sectors. Tax reform in itself is insufficient to dynamize the economy and to improve the equilibrium as it is a one-time change. The tax reform is expected primarily to result in a more realistic evaluation of resources and a regulation which is neutral from the point of view of competition, thereby creating more favourable conditions for decision making at various levels. Nevertheless, tax reform cannot be used as a substitute to the further development of the economic mechanism, the predominance of the monetary sphere, the development of the institutional and organizational system, and last but least, the reinforcement of market mechanisms. If these fail to materialize, the tax reform will not be able to exert a positive influence on the economic processes. Without appropriately limiting market conditions, the introduction of the set of conditions carries the intrinsic danger of being eroded, giving way to earlier conditions, as has been shown by previous experiences. Therefore, the roles of economic management agencies, their management functions, the relationship between management and the managed, and the relationship among enterprises should change together with the introduction of the new set of conditions.

The preconditions for modifying interests and contracts have, in part, been established. The reform of the banking system, the new bankruptcy procedure, the continuous expansion of the forms of capital mobility and the measures linked to the tax reform are closely related, and all point in the same direction.

As the instruments of economic management are becoming more and more diverse and interests, other than those in effect today, are also reckoned with, basic sets of financial instruments, i.e. the fiscal sphere including tax policy, can be relieved from its excessive burdens, primarily from purchasing power control, and be stabilized. In the new structure of the tax system, the parameters of VAT and PIT cannot be changed arbitrarily. The simplification of the taxation

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system of enterprises and the reduction in the role of enterprise taxes under which income for the State Budget is collected have the consequence that the new taxation system is inappropriate to control purchasing power and to provide individual tax exemptions. The basic functions of the new system are to ensure neutrality from the point of view of competition, which implies efforts to avoid distortions in differences of profitability through various control regulations and taxes imposed, and to guarantee the necessary revenues for the Budget. The current, almost exclusively fiscal, measures to control purchasing power and to allocate income should be taken over, to an increasing extent, by the wage control instruments of the monetary policy.

Considering the various elements of the tax and price reform, the introduction of VAT carries special importance. The changes related to the introduction of this type of tax are already of a tax and price reform nature. In current Hungarian practice, income is realized through the prices of various product groups in a highly differentiated way. This is due, in part to the different taxation conditions of the processing phase (including commerce as well) and the differences in taxing consumption (i.e. taxes and subsidies). The positive and negative preferences of the planners and production and turnover coincide in general, although there may be cases where a product group which is highly taxed in production enjoys subsidies at the sale of these goods (e.g. sale of clothing for children).

As a result of the limited number of tax rates, the introduction of VAT will reduce the differences in incomes arising from the sale of goods of the various product groups. The price and tax deflections, alien to the system, will not cause an unbearable burden if only limited to a very narrow range. Therefore, taxation related differences in incomes realized through production prices will be evened out because either the differentiated tax contained in producer prices (including commercial price margins as well) is cut to accommodate VAT or the consumer price level rises with resulting rises in consumer prices.

In Hungary, VAT would replace abolished production taxes as well as the Hungarian turnover tax. This implies that the average rate of consumers' turnover tax will be 12-14% after the tax reform, instead of the (approximately) 4% rate realized on retail turnover on average (which is the balance of taxes and subsidies).

Hungary's turnover tax system at present is a consumption-type tax system. Thus, it affects goods and services which are consumed, at least in theory. In the present system, wholesale trade is selected as the tax point which is relatively close to consumption in the marketing chain to impose tax. Certain commodities, typical consumer goods, are, however, made subject to tax payment irrespective of the point of sale and utilization. This type of taxation harbours certain typical inconsequences as well.

Although the tax point is really close to consumption, input sales are generally not subject to tax, except for sales to small-scale producers (generally in the private sectors, retailers and catering), but taxes are levied on typical consumer goods if used as inputs for production purposes. However, no turnover tax is payable on retail margins, although they may be rather high, which implies that turnover tax is not always and fully proportionate to consumer prices. Consequently, the system has some tax accumulating effects and is not neutral from the point of view of competition.

The present system, with its four rates (0%, 11%, 23% and 30%) has evolved from a differentiated system of several hundreds of rates; nevertheless it is still frequent that products in the same product group are classified into different categories as a result of the rigidity of established consumer price proportions (e.g. clothing for children is zero-rated with a subsidy for certain items, while clothing for adults is in the 23% category).

Although on the basis of the above the present tax system would need adjustments, the real need to reform the turnover tax system has arisen for another reason. The primary objective of introducing VAT is to realize a hitherto larger portion of net revenue through turnover and a smaller portion through production.

Naturally, the changes to be introduced will have to correct current mistakes as well. A further objective is to eliminate even today's minimal commodity tax accumulations and to reduce the direct effects of taxes on supply and demand resulting in differentiations among substitutes, at least in the major product groups. Tax payment obligations should become more straightforward, taxes should be uniform without discriminating between small and large organizations, State-owned companies, cooperatives and private ventures. There is still another fact which must not be disregarded as it may also cause problems. In the current tax system, the supplier is responsible for the collection of tax (if it is selling to buyers obliged to pay taxes), whereas the purchaser is interested to evade taxes.

Some of the objectives to be attained can be achieved simply and automatically by the VAT system; with a small number of VAT rates, supply and demand and the structure of production and consumption can be influenced rationally.

The envisaged legal regulations of VAT do not call for detailed discussion. Basically, the Hungarian system will be in line with international practice. Nevertheless, I would like to set out some of its basic features:

- As planned, the Hungarian VAT system will have 0, 10 and 20% rates (which are not yet final). Basic foodstuffs, such as bread, meat, etc., basic building materials and products for strictly agricultural use (such as fertilizers, seed grain, feed, etc.) and the range of commodities and services that will continue to be subsidized (such as household energy, public transport, both urban and long-distance, and medicines) will be zero-rated.

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Of course, this implies that the current wide-ranging system of consumer price subsidies will be limited when the new system is introduced and the remaining subsidies will be lowered by magnitudes.

- Services, in general, will be in the 10% category.
- The rest of the commodities will be in the 20% category.

As a counterweight against the remaining consumer price subsidies, a consumption tax will be levied on certain consumer goods and luxury items, including spirits, tobacco, coffee, cars, furs, jewellery, etc. The taxes levied on these items are so diverse today that to classify them under a common VAT rate would necessitate considerable movement in consumer prices, meaning undesirable price reductions primarily in the case of spirits and coffee in the first place. Therefore, a decision has been made that in addition to the general VAT rate, special taxation should be maintained here. Relative price changes, arising as a result of the new tax system will be dampened by the subsidies and the consumption tax, at least to some extent.

- In the Hungarian VAT system, few exemptions will be granted, they will concern mostly Budget-contributed services where no revenue is earned and the service rendered is provided practically free of charge (public education, health care).

The threshold for tax exemption will be about half of what has been recommended by the EEC (at 5,000-6,000 ECU).

- The Hungarian system will also use simplified schemes for craftsmen, small businesses and retailers with low turnover. Due to the lack of appropriate equipment, an approximating procedure will be used to calculate the total tax payable by retail outlets, selling goods under different tax rates.

Small farmers will be involved in the system obligatorily only over a specified level of turnover.

- Monthly tax returns will have to be submitted (quarterly or annual ones, if turnover is low) to settle the balance of input and output taxes with the tax authorities.
- Tax to be levied on convertible and non-convertible imports will have a rate identical to that applicable to domestic turnover. The tax base in case of convertible imports will be the customs value plus customs duty; the tax base of non-convertible imports will be the customs value only, as there is no customs duty payable there.
- All exports will be zero-rated. Input taxes on exports will be deductible from taxes on domestic sales or can be claimed back from the tax authority.

The information furnished so far by way of illustration may clarify the major features of the Hungarian VAT and may prove that it does not differ substantially from the solutions employed in 43 other countries of the world.

From the viewpoint of VAT and the tax reform as a whole, the economic environment in general, and two of its specific components in particular are essential, to which the new tax system will be geared.

The introduction of the new taxation and pricing system is not expected to trigger changes in convertible exchange rates. Considering, however, that the level of domestic producer prices should fall, this will result in a relative devaluation since effective imports are not going to become any cheaper, and the import of consumer goods is already expensive. If exchange rates remain unchanged, and as the prices of energy, and raw materials, domestic production as well as the prices of imports from non-convertible sources are geared to world market prices (i.e. these prices will not go down), the range of products involved will become relatively more expensive. Thus, it is obvious that as a result of changes in taxes and prices, producers engaged in less energy, material and import-intensive production will find themselves in a more favourable position, while the status of goods with higher finish will improve in exports.

Hungary's non-convertible foreign trade is governed by agreements between Governments. Due to differences in price ratios, financial bridges are required both in imports and exports to supplement exchange rates to achieve equilibrium in corporate relations in line with the obligations assumed by the Government. Although the role of the financial bridges may be reduced somewhat, they will continue to remain with us.

At present it is especially difficult to comment on the magnitude of tasks involved in purchasing power control arising as a result of the changes in the taxation system and the results of the day-to-day management of the economy in 1988. Although these effects are difficult to isolate, it seems that most of the problems to be tackled are linked to the downward movement of prices on capital goods, the drop in inventory values through taxes collected earlier, along with outstanding debt and the management of deposits. As regards investments, efforts will be made to avoid the distribution of a VAT deduction over a period of several years, or the taxation of capital goods at gradually decreasing rates, but should general consumer friction be noted, the former, rather unappealing solutions cannot be avoided, in all probability.

CONCLUSION

The tax reform that will be introduced in Hungary, although it would be convenient to regard it as such, goes beyond the scope of a domestic issue. Not only for the reason that these changes will have some kind of impact on foreign trade relations through external economic contacts. Also, Hungary is the member of several international organizations and is signatory to agreements on the basis of which it cannot, and will not, effect measures which are contradictory to accepted international practice.

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Furthermore, this goes beyond the scope of a domestic issue as there are approximately 60 joint ventures operating in Hungary today, with about 30 in the process of licensing and commencing activities. They include ventures involved in banking, production, trade and tourism. Hungarian law makes the foundation of joint ventures possible since 1972 (generally, with 49% foreign participation, but the Minister of Finance may approve foreign majority also). Since 1982, businesses with foreign participation may be set up in duty-free zones.

The currently operating enterprises, with foreign interests, joint ventures as well as newly established ones have decided on investment in Hungary and on cooperation with Hungarian partners on the basis of the existing economic environment. The changes to be effected by the tax reform in operating and market conditions which are important to interested parties are not irrelevant for such ventures. The same applies to the pattern of change in the willingness to co-operate with Hungarian enterprises.

The hitherto stable internal political situation, as well as liberal profit and revenue transfer options, favourable tax conditions and relatively low wages allotted to qualified labour were the reasons which made investment in Hungary attractive to foreign venturers. Hungarian enterprises opted for joint ventures with foreign firms primarily to acquire capital and to expand market possibilities to receive tax treatment that is more favourable than applicable to domestic activity.

The tax reform and its impacts will elicit a different awareness in the potential foreign and domestic partners as regards the establishment and operation of joint ventures. The foreign venturer should consider that, as a result of tax reform, labour will generally become more expensive and should the company sell on the domestic market, its taxes will be payable from a decreasing profit margin of decreased prices, as the majority of taxes not levied on a joint enterprise will be abolished. The enterprise should consider that the convertible currency imports needed for its operation will become relatively more expensive in comparison to its accessible domestic price levels and, at the same time, its procurements in Hungary will become cheaper and its exports will clearly become more profitable.

The tax advantage enjoyed by Hungarian investors in the joint venture formation will be deleted or will be substantially decreased as compared to domestic investors, capital involvement will become stronger, as will the motivation to strengthen market positions. Changes in conditions, such as more expensive labour, exports, imports and domestic sales and procurements, are features for a Hungarian entrepreneur independent of the joint venture formation.

The issue of currently existing business associations is characteristic per se and requires special treatment. These are significant in number, and therefore changes expected in this field require thorough review as their business activities were launched in a different economic environment.

Let us look at a simplified example:

A domestic enterprise and a joint venture both supply to the same market. Their major financial parameters (revenues from sales, costs, cost structure and profit) are the same.
The changes to be expected are the following:

- as a result of falling price levels, revenues from sales and material costs will fall alike;
- as a result of the personal income tax, their wage costs are bound to rise;
- their profits will contract to the same extent, although –
  - with domestic companies the rise in wage costs and the contraction of profits will be compensated by the elimination taxes, therefore, the net profits of companies, and the real values thereof will remain unchanged;
  - with joint ventures, the rise in wage costs and the contraction in profits will affect net resources as joint ventures have been paying only a fraction of the taxes to be affected by the proposed changes;
- at the moment of change, the fall in price level will result in a devaluation of inventories due to eliminated taxes. At the micro-level, the relative control and settlement affects corporate property, while at the macro-level it is a matter of controlling purchasing power earmarked for investment, but the reduction in price level should go hand in hand by withdrawing appropriate volumes of money from the economy.

The solution to be applied in the case of joint ventures should not cause reductions in their properties (and there are guarantees to that effect). Although the image of the Hungarian tax reform will, by and large, rely on foreigners' experience gathered through joint ventures, their "regulation" is nevertheless one of the notches in the system which still needs some refinement. This was more or less to be expected since without a more precise knowledge of the general terms and conditions it is not possible to appraise the interrelationship between the changes in price level and profits with a view to the tax burden on joint ventures. The opportunity to cut taxes must not be excluded from the analysis, although in the range of preferable activities that already enjoy considerable tax concessions today, naturally there are constraints in the way of moderating tax burdens. Similarly, in the light of the changing interests of Hungarian companies factors affecting the foundation of joint ventures are to be re-considered, too.

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U.S.S.R.:

Tax Aspects of Joint Ventures

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INTRODUCTION

It has been an agreement with the coordinating committee that my article covers two themes. Therefore, along with the analysis of the provisions of Soviet legislation concerning principles of taxation of joint companies (which is the announced and key topic) the article also embraces a survey of the U.S.S.R. laws in relation to foreign companies and individuals.

Taking into consideration the fact that from 1978-1982 many special publications for those interested in tax matters appeared which gave a thorough and detailed analysis of the main points of Soviet tax laws concerning foreign legal persons and individuals, I presume that the basic principles of these laws are well known to the reader.* Western press has also contributed to the process of disseminating information to business circles and the public, although one has to acknowledge that now and then it gave a false colouring to the situation, with some of the journalists trying to present the Decree of 12 May 1978, adopted by the Presidium of the Supreme Soviet of the U.S.S.R. under the headline "On the Income Tax Imposed on Foreign Legal Persons and Individuals" as a barrier, an obstacle in the way of developing wide-range economic relations with the U.S.S.R.

There were also publications of a much more moderate tone which stated that the Decree filled a gap in the Soviet tax laws and that it wasn't at all something unheard of. On balance the promulgation of the Decree was properly understood by businessmen, attention was drawn to the fact that with all countries of the world becoming more and more active in taxing foreign companies' income, the U.S.S.R. should not deprive itself of the rights which belong to the country by virtue of its law and in accordance with international practice.

We have been quite attentive to those publications. A business-like and thorough analysis of the Decree proved to be very useful and helped to envisage the consequences of the adopted legislative acts and to estimate whether they were in line with international standards or not.

THE ROLE OF INCOME TAXES

It is difficult to overestimate the role of income taxes levied on foreign legal persons and individuals in Budget revenue for the U.S.S.R. On the other hand, one cannot but mention the growing significance, both economic and political, of tax policy of the Soviet State towards these categories of taxpayers.

At present the following taxes may be imposed on foreign legal persons and individuals: the income tax on foreign legal persons; the income tax on population; the tax on the owners of buildings; the land tax; the tax on the owners of transport vehicles; the agricultural tax (applied only to individuals).

Of the taxes enumerated only income taxes and the tax on the owners of transport vehicles are of practical significance as far as foreign companies and aliens are concerned. Other taxes are levied when certain requirements are met whereas in the case of foreigners they are usually not.

The 9 years that passed since the Decree was promulgated showed that practice is rich with a variety of situations which couldn't have been envisaged in the most detailed guidelines. Therefore we are constantly being driven to improve our tax laws.

* See, for instance, *Guides to European Taxation: Volume V, Taxation in European Socialist Countries*, Chapter U.S.S.R., published by the International Bureau of Fiscal Documentation, Amsterdam.

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It is not our intention, however, to make taxation treatment of foreign legal persons and individuals more burdensome, nor are we going to adopt any special sanctions for breaking tax laws. The primary aim is to make the law more explicit and to release it from the wording which might be misleading.

What does a businessman have to know at the start of his activity in the U.S.S.R. in order not to be involved in a conflict with the Ministry of Finance?

Under the Soviet legislation there is an obligation for any foreign company deriving income from its activity in the territory of the country to submit a tax return to the Ministry of Finance before 1 February of the year following the year under report. Due to a number of reasons foreign companies are allowed to submit a detailed survey about their activities in the U.S.S.R. prior to filling in a tax return. It is the task of the tax authorities to define the status of a foreign company on the basis of this information. The decision of the Ministry of Finance is issued to the company which is either notified that it is exempt from taxes in the U.S.S.R. by virtue of internal law or in accordance with the provisions of a relevant agreement, or required to submit additional information necessary for tax assessment.

As a rule it is the most time consuming part of the work connected with taxation of foreign companies. It is at this stage that a common approach is worked out which will be followed for at least several years. Due to the fact that tax treaties to which the U.S.S.R. is a party envisage different taxation treatment for residents of different countries, it is quite common that residents of different countries (which fall within one category of taxpayers) may find themselves in an unequal position as far as their tax status in the U.S.S.R. is concerned. It would have taken too much time to present a detailed analysis or investigation of the reasons for this situation. Still, a better understanding of one of the factors affecting the contents of the U.S.S.R. tax treaties could be provided by reference to an authoritative opinion of "Price Waterhouse". I quote: "Paradoxically, the main purpose of the Decree was not to raise money, but to provide a lever to gain tax exemption for Soviet business activity abroad". It seems Mr. Miles, the author of the article published in February 1982, was a bit puzzled, but right he was in assuming that the idea behind the Decree was to try to exempt income of Soviet organizations and citizens abroad. Raising income in the form of taxes on foreign business has always been a derivative.

In accordance with international practice and the provisions of our tax treaties the taxation of income from business activities in the U.S.S.R. is stipulated by the existence of a permanent establishment in the U.S.S.R. and by the fact of deriving income through this permanent establishment. No attention is drawn to the fact of whether a company is accredited in the U.S.S.R. or not. Many businessmen working in Moscow are under a misapprehension assuming that only those who get registered offices are liable to taxes and are within the scope of Soviet tax authorities. They are usually very much surprised when they are requested to furnish the Ministry of Finance with information about their activities in the U.S.S.R.

It is common practice that any fixed place of business with a certain degree of permanency, e.g. not of a purely temporary nature, through which business is wholly or partly carried on can be treated as a permanent establishment for the purposes of taxation. The activity need not by all means be of a productive character. It need not be permanent in the sense that operations cannot be interrupted, but it has to be carried on on a regular basis.

We usually do not have any serious conflicts at this point with taxpayers because this interpretation of the permanent establishment concept coincides with the commentary on Article 5 of the OECD Model Double Taxation Convention of 1977.

It is common knowledge that any bilateral agreement is a product of a compromise reached by two parties in the course of negotiations, with due attention given to specific features of the relationship between the countries. One cannot feel the logic of a tax treaty without knowing and understanding these features. The Soviet side is always eager to reach a well-balanced and mutually beneficial tax treaty (although the understanding of these concepts may differ from that of our partner's) and we seldom refer to any of our own tax treaties as a model. It is our understanding that every particular agreement mirrors both the interests of the partners, their willingness (or unwillingness) to defend their interests abroad and the extent to which mutual economic relations are developed.

The tax status of foreign legal persons and individuals is to a dramatic extent influenced by the tax treaties of the U.S.S.R. Let me cite several examples. Those who negotiated with the Soviet side are well aware of the fact that the Soviet delegation usually expresses its readiness to agree to significant tax reliefs as far as construction sites are concerned. The reason is that it is our goal to attract companies from developed capitalist countries to the U.S.S.R. and, there are no reasons to conceal it, to gain certain tax reliefs as far as other income is concerned. Therefore the existence of different favourable terms ranging from 12 to 36 months to a large extent is accounted for by our partners' position.

This has a great influence on the character of relationship between a taxpayer and tax authorities. If, for instance, an Italian company gets a "turn-key" project with the anticipated duration of 2½ years, it has only to inform the Ministry of Finance of the U.S.S.R. about the character of the contract; the latter reserves the right to check the actual date of the end of works which might exceed the initially set date. Later the company has to submit to the Ministry of Finance a tax return with the statement of income gained and expenses borne only in case the period of exemption (which in the case of Italy is 36 months) is exceeded.

A similar contract signed by a West German company

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would entail its obligations to declare its proceeds and expenditures on an annual basis. On the other hand, income of a West German company limiting itself to supervision functions (with all the construction and assembly works done by the customer's people) shall not be liable to taxation in the U.S.S.R. by virtue of a special clause in the relevant tax treaty. The Ministry of Finance, however, reserves the right to examine whether the actual activity of the company falls within the scope of the corresponding paragraph of the tax treaty.

The definition of a tax status of individuals is not an easy task. In the absence of an agreement any foreigner deriving income from activity in the U.S.S.R. is liable to tax therein. While negotiating tax treaties, the Soviet Union is ready to accept a generally used 183-day criterion in order to define whether an individual is liable to tax or not. However, many categories of taxpayers enjoy special taxation treatment. A journalist from Great Britain, for example, is hardly aware of and bothered by the existence of Soviet taxes, while he, as well as his Soviet colleagues in London, is exempt from taxes in accordance with the tax treaty with Great Britain. A journalist from Norway starts to pay taxes after a stay of four years in the Soviet Union; American correspondents enjoy a two-year tax exemption while journalists from West Germany are required to submit their tax return in case their presence in our country exceeds 183 days in a calendar year.

Definition of taxable income

As far as the definition of taxable income of a foreign company deriving income from activity in the U.S.S.R. is concerned, there exist two methods: a direct one, where a company is able to declare its profits relating to the U.S.S.R. operations from its own books; and an indirect one, when we have to single out profits from activity in the U.S.S.R. in the total amount of profits with the help of a special formula.

In determining the profits [derived through a permanent establishment], expenses which are incurred for the purposes of a permanent establishment directly connected with the profit-making activities are deducted. Along with the deductions provided for by the guidelines other expenses not specified therein may also be deducted upon approval by the Ministry of Finance of the U.S.S.R.

Depreciation has to be carried on according to Soviet standards, except for cases where the difference accounted for by the use of foreign depreciation norms may be neglected because of its insignificance. It is not allowed to deduct any expenses for tips, gifts or taxes. Expenses have to be documented.

The standard international notional method is often used to define the so-called conventional income. The basis for it is the presumption that the rate of profitability of a commercial activity in the U.S.S.R. should not be less than 15%. A foreign company is issued a payment notice with a tax which is 40% of the taxable income (which is 15% of the expenditures related to profit-making activities).

One could find both advantages and disadvantages in this scheme, but, generally, we regard it as most helpful especially in cases where a taxpayer is unable to fill in a tax return in due order and to present adequate information.

As far as individuals are concerned, the total amount of their income is taxable, including wages, remuneration, bonuses, allowances for living abroad, cost-of-living allowances, etc. The taxpayer is obliged to show his gross income, e.g. before any expenses are deducted. Any additional payments made by the employer, either in cash or in kind, must be added to the declared income.

Recently, several steps were undertaken by the Ministry of Finance of the U.S.S.R. to ensure compliance with the tax legislation. These can be described as follows:

1. Measures undertaken with the purpose of improving registration of foreign companies and their employees in the U.S.S.R. This affects only non-accredited companies because accreditation, which is the form of registration of a company's existence in the U.S.S.R., enables us to keep it under control. Beginning with this year, those companies which are not granted a formal accreditation will be able to conclude or to extend the rental agreement for a certain period only after presenting a certificate acknowledging the fact of registration with the Ministry of Finance.
2. The second set of measures is aimed at stopping the breaking of tax laws. It was in 1983 that a provision was introduced into Soviet law which enables tax authorities to collect taxes for the whole perioid of tax evasion, irrespective of its duration. Earlier there existed a limit of two years.

The law is silent on the definition of tax evasion, but in practice any case where a person has been advised of his duty to submit a tax return at least once or issued a payment notice and failed to comply with these requirements, is treated as tax evasion.

On 1 July 1986 a Decree of the Presidium of the U.S.S.R. Supreme Soviet entered into force which provides different kinds of responsibility for failure to submit a tax return in cases provided by the law, late presentation of a return or presenting false figures or any other false information (with the taxpayer knowing them to be false). Punishment for tax fraud: a person may be subjected to an administrative penalty, e.g. he has to pay a fine of 50-100 rubles; repeated violations of tax laws entail a fine from 200 to 1,000 rubles or a criminal penalty.

Late payment of tax is fined with 0.05% of the overdue payment in case of foreign legal persons and with 0.2% in case of individuals for every day of delay.

The principle of reciprocity provided by the Decree caused quite a stir. It presumes, on the one hand, the

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right of tax authorities of the U.S.S.R. to refrain from taxing companies and individuals from countries where Soviet organizations and citizens are not subjected to taxation, and the possibility of raising or lowering of a tax rate when a higher or lower rate was applied to Soviet organizations and citizens abroad, on the other hand.

The Ministry of Finance is usually well informed about the tax status of Soviet organizations and citizens abroad. Examples could have been cited where, notwithstanding the absence of relevant provisions granting tax reliefs to a certain category of taxpayers, Soviet tax authorities do not tax companies and individuals from a relevant State on the basis of mutual reciprocity.

The problem of altering tax rates seems to be more complicated. We have our eyes open and understand fairly well that one cannot automatically apply a strange tax rate and leave aside a lot of other factors contributing to the determination of a taxpayer's liabilities. Nor do we have the intention of turning our tax system into chaos.

The adverse effects of this idea can be eliminated by implementing this principle in respect of withholding taxes imposed on gross income. The Ministry of Finance, which has had success in altering the tax rate in respect of income from author's rights and international traffic, regards this principle as a guarantee from an unjustified rise of tax rates in respect of Soviet entities and citizens abroad. Of course, we are always ready to react positively where tax rates applied to certain categories of income are lowered by our counterparts.

RECENT TRENDS IN INTERNATIONAL ECONOMIC RELATIONS

The reconstruction which goes on in the Soviet society could not but encompass the sphere of external economic relations of the U.S.S.R. At present a wide range of measures are being undertaken with the purpose of attaching more flexibility to this sphere and to achieve higher efficiency. These steps are an integral part of efforts to improve the economic mechanism as a whole and to bring the national economy up to the highest international standards.

The remolding of the system of international economic relations of the U.S.S.R. was set into gear by two decrees of the Council of Ministers of 19 August 1986, which outlined the main trends of intensifying economic co-operation of the U.S.S.R. with other countries.

These trends include:

- the organizational restructuring of the system of management of external economic relations; the creation of the State Committee on External Economic Relations of the Council of Ministers of the U.S.S.R. with the functions of a central coordinating agency;
- the transition from predominantly trade relations to profound industrial co-operation and specialization in relations with Socialist States. Soviet amalgamations and enterprises are granted extensive rights to develop direct relations with the enterprises and organizations of other Comecon countries. They may choose partners on their own, define the trends and concrete aims of co-operation, set up prices for supplies and services, etc.;
- granting a significant number of foreign trade organizations and enterprises direct access to foreign markets. It means that from 1 January 1987, more than 20 ministries and Government agencies, as well as the 70 largest and most advanced amalgamations and enterprises have the right to carry on direct export-import operations. They may create special funds of currency allocation for financing export-import operations and get credits from the Bank for Foreign Trade of the U.S.S.R. for currency transactions. Nobody has the right to withdraw the balance of currency remaining after an enterprise has satisfied its needs. The economic responsibilities of these entities for the final results of their activities including the non-compliance with delivery plans, have also become a part of their life: any damage done by the entity has to be compensated out of its own currency resources;
- the creation of joint ventures with the participation of Soviet organizations and firms from capitalist and developing countries, as well as the creation of joint ventures, international amalgamations and organizations with the participation of organizations, firms and management agencies from within the Comecon.

The Soviet Union is the sixth country within the Comecon group which has promulgated legislation allowing foreign investment in its national economy. The first five are Hungary, Romania, Czechoslovakia, Bulgaria and Poland. During a long period in the history of our country the opinion was widespread that the concept that the means of production are the property of the whole nation, combined with the system of centralized planning, and did not allow for the idea of investing foreign capital into the socialist economy in any form. However, a new situation has put forward new ideas, which, in their turn, gave birth to new instruments for the implementation of these ideas.

The analysis of the external economic relations of the U.S.S.R. showed that the Soviet Union does not occupy the position in the international economy which it should have occupied judging from its industrial, material, scientific, technical and human resources. Therefore the creation of joint ventures in the U.S.S.R. has in view:

- to achieve certain objectives which contribute to the development of the national economy; to accelerate the introduction of certain modern technologies; to raise the technical quality level of the production and services;
- to promote and develop scientific research activities;
- to satisfy the domestic demand for certain types of

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manufactured products, raw materials and foodstuffs;
- to attract advanced foreign equipment and technology, as well as additional material and financial resources;
- to learn from modern methods of enterprise management; and
- to expand the national export sector and to reduce superfluous imports.

JOINT VENTURES

Obviously, it is necessary to make several preliminary remarks before the survey of legislation, in the first instance, tax legislation in respect of joint ventures.

First, the Soviet Union is a newcomer to the ranks of those socialist countries which are attracting foreign capital in the form of joint ventures. It is quite natural that the experience of the Comecon countries and the People's Republic of China have been taken into account by Soviet experts.

At present there are more than 700 joint ventures functioning within the Comecon group, about 2,000 joint ventures operate in China and almost 200 in Yugoslavia. The total value of foreign capital invested in Comecon countries' mixed companies does not exceed US$ 200 million, which constitutes only 0.1% of the total value of fixed assets. Therefore one should not overestimate the role of joint ventures in the socialist economy; it is also clear that the latter does not depend on foreign investment.

At the same time, arriving at a decision to create joint ventures in its territory, the Soviet Union looks forward to the prospectives of this new form of economic co-operation.

Second, we are far from dreaming that the promulgation of the relevant legislation will bring about a mushroom growth of joint ventures. We understand that our potential partners need time to give due consideration considering their resources and the opportunities suggested by the Soviet Union; they also have to weigh all the possible consequences of their participation in this form of business with Soviet enterprises. Some stick to the wait-and-see policy.

We are also aware that not all the provisions of the new legislation are perfect; therefore, one cannot exclude the possibility of changing some details as time passes and we gain some experience.

Apparently not all of the numerous problems connected with the activities of joint ventures are worked out in a sufficiently detailed manner. One should not be too pessimistic about this and treat all these factors as an insurmountable obstacle in the way of joint ventures. We feel that Western businessmen are sceptical about some provisions of our legislation. Some of them do not like the idea of putting 51% of the authorized capital into the hands of Soviet partners; other are opposed to the necessity of observing Soviet laws concerning labour relations. There are also many other points to which it is rather difficult to bring our views in accord with the views of Western businessmen. We do not pretend to know all the answers, but we are determined to seek them in a positive way.

Every undertaking, especially that which involves changes in the way of thinking, inevitably faces a lot of difficulties; we hope that they will be overcome provided there is mutual desire for success, readiness to reach compromises, flexibility and reciprocal goodwill.

At the same time one cannot except that the Soviet State, while using new forms of economic co-operation, will go from one extreme to the other. One cannot bring into question the principle of State monopoly for foreign trade and currency operations and the obligation imposed on foreign partners to adhere to Soviet laws and regulations. On the other hand, both the Soviet State and Government agencies will strictly observe the principles of securing mutual benefits and guarantee the interests and rights of foreign partners.

The law says that a joint venture acquires the rights of a legal person since the moment of its registration with the Ministry of Finance of the U.S.S.R. State-owned, co-operative, public and other organizations and entities are prohibited from concluding any contracts or negotiating any deals with a joint venture prior to its registration. The State Bank of the U.S.S.R. and the Bank for Foreign Trade of the U.S.S.R. will open accounts and start operations only after a joint venture is registered following the proper procedure.

The registration of a joint venture takes place upon presentation of a written application of its partners and copies of the following documents certified at a notary's office:
- an extract from the resolution of the Council of Ministers of the U.S.S.R. on the establishment of a joint venture;
- founding documents (e.g. the agreement on the establishment of a joint venture and its charter).

A joint venture is also obliged to submit, upon request of the Ministry of Finance of the U.S.S.R., other documents certifying the reliability of information to be inserted into the register.

The Administration of State Revenues of the Ministry of Finance of the U.S.S.R. informs a financial authority in the territory of which a joint venture is located about its registration. Later on this financial authority will be responsible for control over the settlement of payments of a joint venture to the State Budget.

The law does not specify which level of financial authority will be in charge of these functions; it is evident that at first, before sufficient experience is gained, each case will be settled separately, the Ministry of Finance of the U.S.S.R. taking into account a variety of factors, not the least of them the qualifications of the personnel.

The registration of a joint venture is effected by means of inserting necessary information into a special register. The fact of the registration is confirmed by a

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certificate which enables it to publish information about its establishment. Information included into the register and published in compliance therewith is considered to be known to third parties; no disputes in connection with this are liable to consideration by the Ministry of Finance of the U.S.S.R.

Liquidation of a joint venture (which event may take place according to mutual agreement of the partners, in the cases and in the manner stipulated by the founding documents and also by a decision of the Council of Ministers of the U.S.S.R. if the activities thereof run counter to the objectives and principles set up in these documents) has also to be registered with the Ministry of Finance.

The law allows joint ventures to create affiliates. Affiliates which have the status of legal persons are also liable to registration under the same procedure.

Registration is effected free of charge.

The matters of taxation of joint ventures with the participation of companies from capitalist States are governed by two legislative acts: the Decree of the Supreme Soviet of the U.S.S.R. of 13 January 1987 "On Questions Concerning the Establishment on the Territory of the U.S.S.R. and Operation of Joint Ventures, International Amalgamations and Organizations with the Participation of Soviet and Foreign Organizations, Firms and Management Bodies" and the Decree of the Council of Ministers of the U.S.S.R. of 13 January 1987 "On the Establishment on the Territory of the U.S.S.R. and Operation of Joint Ventures with the Participation of Soviet Organizations and Firms from Capitalist and Developing Countries". With these titles being too long for common use, they will be referred to as "the Decree".

Due to the fact that taxes, being a category of public finance, may be imposed only by the State, the taxes on the profits of a joint venture and on the part of profits of a foreign partner transferred abroad are imposed by the Decree of the Supreme Soviet which is the legislative body. The Decree, which is very short, delegates to the Government the powers to define concrete rates of taxes and the rules of operation of joint ventures. This has been done to make the system more flexible.

Special rules for settling up with the State Budget had to be developed. This is mainly explained by the fact that it is impossible to apply the existing system of relationship between Soviet enterprises and the Budget because of its complexity and diversity. Those who are interested in the development of the economic mechanism in the U.S.S.R. might have read that in recent years an experiment has been carried on in many sectors of the national economy with the aim of putting the interests of a separate enterprise, on the one hand, and of the society, on the other, under one roof. Under the experiment going on in the country, a unilateral scheme for the system of payments to the State Budget which could be applied to different enterprises has not yet been singled out.

A new mechanism which would combine both simplicity and effectiveness and would enable a joint venture to operate within the framework of the Soviet economy and carry on activities on the basis of full cost accounting, self-support and self-financing had to be created.

The rate of tax which is imposed on taxable income of the joint venture is 30%. It is worth mentioning that the rate of tax was a subject for serious debate. Account was taken of the available information about effective tax rates in Western countries and of the legislation of socialist States.

No tax expert would disagree with the statement that the tax rate as such does not of itself give a correct impression about tax burden. It is the regulations governing the definition of taxable income which usually dramatically influence the amount of tax. In the U.S.S.R. taxable income is defined as the difference between the balance value of profits and allocations to a reserve fund as well as to other funds earmarked for the development of the production, science and technology.

Obviously, it is necessary to say a few words about funds. In conformity with the Decrees it is obligatory for a joint venture to set up a reserve fund and other funds necessary for its operation and the social welfare of its personnel. In contrast with some other socialist countries, the U.S.S.R. gives the partners of a joint venture the right to decide which part of the book profits will be allocated to the reserve fund used to cover unforeseen expenses and losses. It is our understanding that partners to a joint venture will determine the share of profits destined to enlarge the reserve fund taking into account that it is economically unreasonable to accumulate too much in this account. The only limitation as far as the reserve fund is concerned is the requirement that its size should not exceed 25% of the authorized capital.

The fund earmarked for the development of the production, science and technology is also a very important factor in defining taxable income. In conformity with Soviet law all enterprises (including joint ventures) which operate on the basis of full cost accounting, self-financing and self-support may use this fund to cover the expenses for:

- the re-equipment, reconstruction and expansion of the production;
- the mastering of new and modernized production, introducing up-to-date technological processes;
- carrying on scientific research and project works, purchasing licences, machines and equipment;
- compensating for increased expenditures arising in the process of introducing new production;
- paying off long-term and other bank credits, as well as interest;
- other expenses the financing of which is envisaged by Soviet laws.

One can see from this list that the purposes for which this fund is destined are wide-ranging. In general terms, the fund is set up to secure normal operating conditions of a joint venture.

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A joint venture may also set up other funds which, however, do not constitute allowable deductions for tax purposes and may be created after the State Budget gets its share.

There is no loss relief as such, as losses are first chargeable against the untaxed reserve fund.

In order to secure favourable economic conditions for the joint ventures in the U.S.S.R., the Council of Ministers decreed that they will enjoy several tax reliefs. A start-up relief is available in so far that there is an unconditional tax exemption for the initial two years of a joint venture's operations. Furthermore, the Ministry of Finance is granted the authority to reduce or waive taxation for separate taxpayers. The guidelines of the Ministry of Finance of the U.S.S.R. do not contain a list of factors upon which a joint venture may depend for valid reasons to apply for tax relief. Obviously the most convincing argument for the Soviet tax authorities would be reference to serious financial difficulties of an enterprise.

It is foreseen that at the moment of submitting all the documents pertaining to tax calculations to a relevant financial authority a joint venture seeking for a tax relief has to present an application stating the reasons for its appeal. The financial authority has to check whether an appeal is justified or not and present its findings to the Ministry of Finance of the U.S.S.R. which makes a decision within a month.

A certain vagueness in the conditions of granting tax relief by the Ministry of Finance of the U.S.S.R. may give rise to apprehension. One may feel that the Ministry has powers too broad, enabling it to execute or to favour a taxpayer quite arbitrarily and that a joint venture would not know the cases under which its appeal might be satisfied. The standpoint of the Soviet tax authorities is the following. An ability of any economic unit to operate on the basis of full cost accounting and self-support means that it has a sufficient rate of profitability and, consequently, has to pay a tax. Granting a tax relief is aimed at rendering temporary financial assistance to an enterprise in distress. However, one cannot exclude the possibility that an appeal of an enterprise will be satisfied when, for instance, the activities of a joint venture contribute to the expansion of the export sector of the economy.

The Ministry of Finance of the U.S.S.R. is ready to take into account all the circumstances and reasons which force a joint venture to seek a tax relief and will give thorough consideration to each case. We are also ready to use the right granted to the Ministry of Finance by the Government, and our present attitude is one of goodwill rather than the reverse.

The share of annual profits of a joint venture attributable to a foreign investor is subject to a tax at the rate of 20% when transferred abroad. To the extent that the profits remain in the U.S.S.R., the rate is reduced to zero. Since the Soviet Union has a wide network of tax treaties this may prove to be of considerable advantage to a foreign investor. Under the majority of tax treaties of the U.S.S.R. the tax rate is reduced on profits attributable to an investor resident in the other State and transferred abroad. The only exceptions are tax treaties with the U.S.A., Finland and Switzerland (the latter is not yet in force) where an Article on dividends is absent.

The Ministry of Finance of the U.S.S.R. has introduced a certification system which requires, as a condition to securing treaty benefits for the U.S.S.R.-source investment, that a person claiming the benefits obtain a certificate of eligibility for treaty benefits from the competent authority of the appropriate treaty partner. The system requires that the full withholding of the 20% tax is effected followed by a refund to the person claiming the treaty benefits. The form of the certificate is to be obtained from the Soviet partner of the joint venture. The certificate of eligibility has to be submitted to the Ministry of Finance of the U.S.S.R. within one year from the moment of transfer. Any appeals presented later than one year shall not be considered by the Ministry.

Joint ventures also enjoy a number of important exemptions from customs duties. These extend to equipment, materials and other property imported into the U.S.S.R. by foreign partners in a joint venture as their contribution to the authorized fund. Sales by the joint venture are not liable to the turnover tax.

As far as accounting principles are concerned, joint ventures have to use standard Soviet regulations issued by the Ministry of Finance of the U.S.S.R. These are based on an accrual concept. Depreciation of fixed assets is on the basis of standardized tables with straight-line rates. The Decree provides, however, that the founding documents may lay down other principles of depreciation.

The assessment of the tax on profits shall be effected by a joint venture which is responsible for the correctness of tax calculations, submitting of tax returns in due time. The advance tax payments for the current year shall be determined on the basis of the financial plan of the joint venture.

The assessment of the final tax amount on the profits actually made shall be effected not later than 15 March of the year following the year under report.

The amount of tax on profits for the current year shall be transferred to the Budget by equal quarterly instalments. Late payments will be overcharged at the rate of 0.05% for every day of delay. The recovery of delayed payments will be enforced in accordance with the provisions of Soviet law applicable to foreign legal persons, e.g. through a court procedure.

The final settlement of the tax has to be done not later than 1 April of the year following the year under report. The over-payment is either credited to the account of the taxpayer or refunded within 5 days upon the appeal of the joint venture.

A joint venture has the right to appeal against actions of financial authorities which have the right to verify tax calculations. An appeal has to be lodged with the financial authority which checks tax assessment; each

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case has to be decided within one month of the date the appeal is lodged. The appeal has to be lodged within one month of the date of receipt by a joint venture of a notification from the financial authority about the results of its findings; otherwise the appeals are not considered and the decision of the financial authority is deemed to be final. There is also the right to appeal against the ruling of the local financial authority before a superior financial authority within one month of the date of the ruling.

Foreigners who will be employed by the joint venture are subject to income tax at the rates applicable to Soviet citizens, unless otherwise provided in a tax treaty.

CONCLUSION

These are the main provisions of the Soviet laws affecting future joint ventures. In our opinion, foreign investors may benefit from the use of this new form of economic co-operation with our country. There was no intention to create a law which would hamper the establishment of joint ventures. On the other hand, it would have been unwise to expect that our country's tax climate would be that of a "tax haven".

On 12 May 1987, the first joint venture has been registered with the Ministry of Finance of the U.S.S.R. The participants are the Soviet organization "Littara" (Vilnius) and the Hungarian enterprise "Volanpack". The name of the joint venture is "Littara-Volanpack", registration number one. We expect other foreign participants to follow suit.

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Bibliography

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UNITED STATES:

Taxation of East European-Source Joint Venture Income

By Howard M. Liebman

As is quite well-known, the United States has a highly detailed set of tax legislation, with many complex provisions as well as even more complex regulations and interpretative rulings, relating to the taxation of international transactions. The purpose of this article is merely to summarize some of the key issues and constraints which presently exist – with particular attention to the recently-enacted provisions of the U.S. Tax Reform Act of 1986 – as regards investments by U.S. companies in Eastern Europe.

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I. U.S. TAX CONSEQUENCES OF ESTABLISHING A JOINT VENTURE

A. In general

The capitalization of a company, whether U.S. or foreign, purely by means of a capital contribution of cash in exchange for shares will be tax-free to both the transferor and the transferee under U.S. tax law.[1] If, in the alternative, the company is capitalized wholly or in part by the contribution of "property", a different regime may be applied. Pursuant to I.R.C. Section 351(a), no gain will be recognized to the transferor of property transferred to a corporation by one or more persons "solely in exchange for stock or securities in such corporation" if, immediately after the exchange, such person or persons are in "control" of the transferee. "Control" is defined in terms of the ownership of at least 80% of the "total combined voting power of all classes of stock entitled to vote and at least 80% of the total number of shares of all other classes of stock of the corporation".[2]

It is thus feasible for contributions of "property" to any Eastern European joint venture to qualify for this tax-free treatment, at least pursuant to the laws currently extant permitting joint ventures in Eastern Europe. This is because the control group is defined as those persons who jointly contribute property and/or cash to the corporation as part of the same overall transaction. On the other hand, such treatment may not be available in the case of a de-nationalization of an existing State-owned entity.

B. Transfers of intangibles

An issue which most often arises in the context of the establishment of a joint venture entails the tax consequences of transferring to it intangible property, and particularly patents, copyrights, trademarks and know-how. Such intangible property has historically been of particular interest to Eastern European joint venture partners which are eager to obtain the latest technology to assist in boosting exports and foreign currency revenues.[3] In this context, the question arises as to whether or not such intangibles qualify as "property" for purposes of the tax-free capital contribution provisions of U.S. law.

A variety of factors will usually be considered in determining such a characterization, but the primary factor has tended to be whether or not the intangibles are "secret" and as a result a value may be deemed to have attached to them.[4] Absolute secrecy is not necessary, however.[5]

1. See U.S. Internal Revenue Code of 1986 ("I.R.C.") § 1032(a) (tax-free receipt of cash contribution by corporation).
2. I.R.C. § 368(d)(1).
3. Cf. Pattison & Klingenberg, "Soviet Announcement Should Stir Interest of U.S. Corporation", *Legal Times*, 2 March 1987, at 12, 13.
4. See Rev. Rul. 71-564, 1972-2 C.B. 179; Rev. Rul. 64-56, 1964-1 (Pt. 1) C.B. 133; Rev. Proc. 69-19, 1969-2 C.B. 301.
5. See generally Heyde, "Transfers of Technology: The Appropriateness of Capital Gain Treatment", 64 *Taxes* 3, 4 (January 1986).

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Obviously in order to qualify as a transfer of property without tax consequences to the transferor, the transaction must be characterized as a "sale or exchange" rather than a license. In the past, this distinction also was important for determining whether or not any taxable income recognized on the transfer would be subject to ordinary income tax rates in the case of royalty income from a license or capital gains tax upon the sale of a bundle of intangible rights. This distinction is no longer of direct relevance in view of the elimination of the special capital gains tax rates following the U.S. Tax Reform Act of 1986.[6]

Nonetheless it will still prove important to determine the proper characterization as the same standards also provide guidance as to whether or not an intangible will qualify as "property" for I.R.C. Section 351 purposes. Finally, the source of any taxable income to be recognized on the transaction will potentially vary depending upon whether the transaction is deemed to be a sale of "property" or a license of intangibles.[7]

Of course the formalities of the transaction will present a starting point for any such analysis, but the mere labelling of the transaction as a "sale or exchange" may not be accorded any legal effect under U.S. tax law if certain substantive attributes do not also attach thereto.[8] Basically, in order to constitute a sale of intangibles, there must ordinarily be a transfer of "all substantial rights" thereto or at least exclusive rights in a defined geographic area. The grant must be exclusive until the secret or proprietary information contained therein becomes public knowledge and is no longer protected under local law.[9]

Although exclusivity is difficult to enforce in the case of unpatented or non-copyrightable intangibles, it will usually prove sufficient if the transferor contractually binds itself not to sell the same rights to other persons. The clearest case of a "sale or exchange" of a pure intangible (such as know-how) is a grant of an exclusive and perpetual right to make, use and sell same within a defined territory.[10] The transfer should also include the right to prevent the unauthorized use of the intangibles, particularly if it is not protected under the local laws in the country of use.[11]

In particular, it should be noted that any restrictions on the rights to use the intangible may be viewed as destroying its characterization as "property". A transfer of a limited duration with the ability to terminate the rights conferred "at will" or with certain field-of-use restrictions would probably not qualify.[12] The primary element with regard to the insertion of restrictions on the scope of a transfer of any intangibles is whether such restrictions result in any substantial, continuing interest in or control over the intangible or in the conduct of the transferee's business on the part of the transferor or whether the restrictions are merely ancillary to the protection of the transferor's own contractual position.[13]

Thus retention of bare legal title to secure performance should not prove a problem.[14] Nor will conditions subsequent allowing for a termination of a grant under specified circumstances[15]: geographic limitations[16], a retained right to sue for infringement[17], limitations of use to a particular industry or product[18], exclusivity subject to existing non-exclusive licenses[19], or a grant-back of a license to sell in a certain territory or a reservation of such a right where required by applicable antitrust laws[20], depending upon the precise facts and circumstances.

There is a major caveat with regard to the above discussion, however, as I.R.C. Section 351 does not automatically apply in an international context. Instead, it is overridden to a large extent by another provision, namely I.R.C. Section 367, which states as a general rule that transfers of property by a U.S. person to a foreign corporation will not qualify for tax-free treatment under, inter alia, I.R.C. Section 351.

As a result, an "outbound transfer" of (particularly) appreciated investment-type assets as well as ordinary income-generating assets to a foreign corporation, including a joint venture, will result in a "toll charge" (or ordinary income tax assessment) being imposed on the inherent gain in the property so transferred.[21] There are a number of exceptions, including one for property which will be used in the conduct of an "active trade or business outside of the United States".[22] However, certain "tainted assets" will be subject to tax on an "outbound transfer" even if they will be used in an "active trade or business", specifically:

(i) inventory and stock-in-trade;

6. H.R. 3838, Pub. L. No. 99-514, 99th Cong., 2d Sess. (22 October 1986).
7. See generally Swenson, "Modifications to the Source of Income and Deductions Rules", in *The Tax Reform Act of 1986: Detailed Analysis* (BNA), 986 T.M. (Vol. 2) at 61:1 (1987).
8. Cf. Freling, "Sales of Intangible Business Assets", 14 *Tul. Tax Inst.* 209, 238 (1965).
9. Rev. Rul. 71-564, supra note 4.
10. See *E.I. DuPont de Nemours & Co. v. U.S.*, 288 F.2d 904 (Ct. Cl. 1961); Rev. Rul. 64-56, supra note 4.
11. See *Stalker Corp. v. U.S.*, 209 F. Supp. 30 (E.D. Mich. 1962). Cf. Rev. Proc. 69-19, supra note 4, at § 2.01 (emphasis on importance of substantial protection against unauthorized disclosure under law of transferor), amplified by Rev. Proc. 74-36, 1974-2 C.B. 491 (noting that Revenue Procedure 69-19 is also applicable to rulings on transfers of computer software under I.R.C. Section 351).
12. See *Fawick v. Comm'r*, 436 F.2d 655 (6th Cir. 1971); *Taylor-Winfield Corp.*, 57 T.C. 205 (1971), aff'd 467 F.2d 483 (6th Cir. 1973); *PPG Industries, Inc.*, 55 T.C. 928 (1970); *Arthur M. Young*, 29 T.C. 850 (1958), aff'd 269 F.2d 89 (2nd Cir. 1959).
13. See *Condé Nast Publications, Inc. v. U.S.*, 575 F.2d 400 (2nd Cir. 1978).
14. Cf. Treas. Regs. §1.1235-2(b)(2)(i).
15. *Carl G. Dreymann*, 11 T.C. 153 (1948), acq. & nonacq., 1950-2 C.B. 2, 5. Cf. Treas. Regs. §1.1235-2(b)(2)(ii).
16. See *Vincent A. Marco*, 25 T.C. 544 (1955), gov't's appeal dismissed by stipulation (26 July 1956), acq., 1958-2 C.B. 6.
17. *Watson v. U.S.*, 222 F.2d 689 (10th Cir. 1955).
18. *Condé Nast Publications, Inc.*, supra note 13; *Carruthers v. U.S.*, 219 F.2d 21 (9th Cir. 1955); *First Nat'l Bank of Princeton v. U.S.*, 136 F.Supp. 818 (D.N.J. 1955), gov't's appeal dism'd (1956).
19. *Bell Intercontinental Corp. v. U.S.*, 381 F.2d 1004 (Ct. Cl. 1967); *Rollman v. U.S.*, 244 F.2d 634 (4th Cir. 1957).
20. Cf. *E.I. DuPont de Nemours & Co. v. U.S.*, 432 F.2d 1052 (3rd Cir. 1970); *PPG Industries*, supra note 12.
21. I.R.C. §367(a)(1).
22. I.R.C. §367(a)(3)(A).

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(ii) accounts receivable;
(iii) installment contracts;
(iv) non-marketing intangibles to be used in a U.S. trade or business or the sale abroad of U.S.-manufactured goods;
(v) stocks and securities and other assets producing passive income;
(vi) foreign currency or foreign-currency denominated property; and
(vii) property leased or licensed by the transferor unless the transferee was the lessee.[23]

A special rule which was inserted in these provisions with regard to the transfer of intangibles abroad as a part of the U.S. Tax Reform Act of 1984,[24] is now contained in I.R.C. Section 367(d). The latter provision treats the proceeds from the use of intangibles transferred in what would otherwise qualify as an I.R.C. Section 351 transaction as periodic, deemed royalties to the transferor, in an amount based on the use and productivity of the transferred intangible as *if it had been* licensed.[25] For these purposes, intangible property is generally defined as any knowledge, right, document or any other item referred to in I.R.C. Section 936(h)(3)(B).[26]

It should be noted, however, that the right to use a corporate name in a foreign country will be treated as "foreign goodwill" or "going concern value" and hence will *not* constitute "property" for these purposes.[27] Nor will copyrights and/or similar property held by someone who personally created them.[28]

Pursuant to this deemed license/royalty approach, the U.S. transferor will be treated as receiving annual payments contingent on the productivity or use of the transferred property over its useful life.[29] If, for some reason, I.R.C. Section 367(d) is inapplicable, the intangibles covered by these rules may be treated as "tainted assets" and subjected to an immediate "toll charge" on any inherent gain in the property being transferred.[30]

These rules do not apply to an actual sale or license of intangible property.[31] Of course, the major concern in this case is what level of royalty or what sales price will prove satisfactory, both for U.S. and foreign tax purposes.[32] If the sale or license is a sham, the rules of I.R.C. Section 367(d) will still apply – rather than the normal transfer-pricing rules of I.R.C. Section 482 – in order to determine the tax liability to the U.S. transferor.[33]

Nonetheless, it can be envisioned that the principles of I.R.C. Section 482 will have some application, since the intent is that the transferor be deemed to have received income derived from "an appropriate arm's length charge" for the use of the property, that being most often determined under the case law and regulations underlying I.R.C. Section 482.[34] The reallocated income will be treated as ordinary taxable income and deemed to be from U.S. rather than foreign sources.

Ordinarily it is expected that the useful life of intangible property will not exceed 20 years.[35] If the royalty is not actually paid by the foreign transferee, an account receivable may be created on the books of the U.S. transferor and no interest need be accrued on such accounts. On the other hand, no bad-debt deduction will be allowed for any failure to pay the receivable, and if it is not paid on the last day of the third taxable year following the year to which the account relates, the amount will be deemed paid on that date.[36]

Finally, it should be noted that U.S. Treasury Regulations have also been promulgated under I.R.C. Section 6038B, requiring extensive reporting with regard to "outbound transfers" of "U.S. property". The information required to be filed must be attached to a U.S. Internal Revenue Service ("IRS") Form 926 and attested to under penalties of perjury by the U.S. transferor.[37] In the case of a transfer of intangibles, detailed information must be provided concerning the identity of the U.S. transferor, the intangible property which is transferred and the consideration received, an estimate of the fair market value of the intangible, and the like.[38]

Technically, a notice is due even for a transfer of a corporate name to a foreign subsidiary, even though such a transfer is exempt from either a deemed royalty or "toll-charge" under I.R.C. Section 367(d).[39] The IRS' position has been criticized, but "[n]evertheless, it would be prudent to file [the notice] for all foreign subsidiaries formed on or after January 1, 1985" since the penalty for failure to file is 25% of the value of the name.[40] As one commentator has noted,

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23. I.R.C. §367(a)(3)(B). See also Rev. Proc. 68-23, 1968-1 C.B. 21, at §3.02.
24. H.R. 4170, Pub. L. No. 98-369, 98th Cong., 2d Sess., at §131 (18 July 1984). See generally Billings, Putnam & Nixon, "Foreign Transfers of Intangible Property Rights", 65 *Taxes* 186 (March 1987).
25. I.R.C. §367(d)(2)(A)(ii). See also Addendum on page 466.
26. Temp. Treas. Regs. §1.367(a)-1T(d)(5)(i). The referenced definition specifically includes copyrights, trademarks, trade names and brand names. I.R.C. §936(h)(3)(B)(ii) & (iii).
27. Temp. Treas. Regs. §1.367(a)-1T(d)(5)(iii). See also Rev. Rul. 79-288, 1979-2 C.B. 139.
28. Temp. Treas. Regs. §1.367(d)-1T(b).
29. Temp. Treas. Regs. §1.367(d)-1T(a). This is an "elusive concept" and can result in the deemed royalty actually exceeding what would have been the "toll charge" had the intangible been treated as a "tainted asset" under the general provisions of I.R.C. Section 367(a). Terr & Safranek, "Transfers of Property Outside the United States – §§367 & 1491", in *The Tax Reform Act of 1984* (BNA), 984 T.M., at A-551, A-567 (1984).
30. I.R.C. §367(a)(3)(B); Temp. Treas. Regs. §1.367(d)-1T(b). See Rev. Proc. 68-23, supra note 17. Some of the technical instances in which the "tainted assets" provision will override the royalty imputation treatment are discussed in Mogenson & Sparagna, "Outbound Transfers – An Analysis of the New Regulations Under Section 367", 15 *Tax Management Int'l J.* 271, 279-281 (8 August 1986).
31. See Temp. Treas. Regs. §1.367(d)-1T(g)(4).
32. See generally Aud, Wright & Henry, "Post-Section 367(d) Strategies for Transferring Intangibles Overseas", 14 *Tax Management Int'l J.* 411, 416-418 (13 December 1985).
33. Temp. Treas. Regs. §1.367(d)-1T(c)(4)(ii).
34. Temp. Treas. Regs. §1.367(d)-1T(c)(1). The formal inapplicability of I.R.C. Section 482 will affect the source of the deemed income for foreign tax credit purposes. See Mogenson & Sparagna, supra note 30, at 285.
35. Temp. Treas. Regs. §1.367(d)-1T(c)(3).
36. Temp. Treas. Regs. §1.367(d)-1T(g)(1).
37. Temp. Treas. Regs. §1.6038B-1T(b)(1).
38. Temp. Treas. Regs. §1.6038B-1T(d).
39. See note 27 supra.
40. Taxes Int'l No. 82, at 82 (Aug. 1986).

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> There is simply no substitution for a very thorough analysis and review of these rules to make sure they are fully satisfied in timely fashion to avoid any gain being recognized or penalty. No provision is made for substituting a ruling from the IRS for any of the information required to be furnished. Nor do the information requirements of these regulations take the place of any other information to be furnished, ...[41]

The U.S. Tax Reform Act of 1986 amended these provisions further and creates yet an additional, potentially-troublesome concept. Specifically, the latest provisions would seek to impose a tax liability on a so-called super-royalty accruing from the outbound transfer of intangibles by deeming all eventual income "commensurate with" their use as being paid or payable to the transferor.[42] The basis for this amendment was the concern of the U.S. Congress that arm's length rates based on industry norms or transfers of other (less valuable) intangibles to unrelated parties may not be reliable benchmarks for establishing the appropriate transfer price for such intangible property.[43]

In order to more closely relate the amount of income recognized by the transferor to the amount of income which the use of the intangibles subsequently yields, Congress has modified the provisions which impose an arm's length standard on such transfers.[44] Thus, to the extent there are major fluctuations in the income produced by an intangible over its life, the transferor will be required to adjust its annual recognition of income.[45]

Recent U.S. Treasury Department indications are that the final rules which will be promulgated, following the termination of the regulations project currently under way, may soften the impact and limit the scope of the "super-royalty" to "hot property" transfers to tax havens.[46] This is based on the original policy intent to limit the ability of U.S. drug manufacturers to transfer potentially-valuable patents and know-how to Puerto Rican subsidiaries and thereby generate the eventual revenue from the manufacture and sale of those products in a tax-advantageous "possessions corporation".

Nonetheless, the IRS has argued in the recent *G.D. Searle* case[47] that the revenue to be earned by the foreign manufacturer should not be any greater than that which a "contract manufacturer" would derive. The recently-issued "Bluebook", which arguably evidences Congress' legislative intent, indicates that Congress did not, however, intend to mandate "the use of the 'contract manufacturer' or 'cost-plus' methods of allocating income or any other particular method .... [instead] all the facts and circumstances ought to be considered ...".[48] Since intangibles for these purposes are so broadly defined,[49] it will now be extremely difficult for a U.S. joint venture partner to transfer intangibles to an Eastern European joint venture without either accepting a tax risk or negotiating up-front for the intangible to be remunerated on the basis of a potentially high royalty.

This will of course generate substantial problems with regard to repatriation issues – investment approvals and exchange controls – in the Eastern European countries involved. In particular, if the "super-royalty" concept is indeed broadly construed, it will not be easy to set the necessary royalty rate ahead of time with any certainty. It may therefore be envisioned that substantial tax disputes will arise with a potential for double taxation.[50]

In the absence of regulations in this area, the only potentially-practical solution from a U.S. tax point of view, short of negotiating a "super-royalty" provision with the Eastern European joint venture partner, is to arrange a cost-sharing arrangement, under which the cost of research and development will be shared between the two joint venture partners via the joint venture with the result that any technology developed and/or intangible created will then be considered jointly owned. Consequently, the joint venture would have the right to use the intangible property created without the payment of any further compensation.[51] Any such arrangements will of course require substantial cooperation and understanding on the part of the Eastern European joint venture partner and the ministerial representatives/negotiators of the country in question. From a purely commercial point of view, such a solution may not prove feasible in many cases, however.

For the sake of completeness, it should be noted that a 35% excise tax is imposed on the unrecognized gain resulting from transfers of property to a foreign corporation as paid-in surplus or a capital contribution or on transfers to, for example, a foreign partnership.[52] This tax is levied on the difference between the fair market value and the adjusted basis of the assets being contributed. This excise tax is not applicable, however, if I.R.C. Section 367 applies.[53] Hence it is primarily of interest in the case of capital contributions to foreign partnerships or other corporate entities.

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41. Friedman, "New Temporary and Proposed Regulations under Sections 367(a), (d) and 6038B", 27 *Tax Management Mem.* 251, 268 (29 September 1986).
42. See Summary of the Conference Agreement, reprinted in *U.S. Tax. of Int'l Operations* (P-H) Suppl. 61 (2 September 1986).
43. H.R. Rep. No. 99-426, 99th Cong., 1st Sess., at 424-425 (1985) (the "House Report").
44. See I.R.C. §§367(d)(2)(A) & 482.
45. House Report, supra note 43, at 425-426.
46. See e.g. *Daily Tax Rep.* (BNA) No. 31, at G-1 (18 February 1987) (comments of Mr. S. Shay, International Tax Counsel, U.S. Treasury Department).
47. *G.D. Searle & Co.*, 88 T.C. —, No. 16 (4 February 1987).
48. General Explanation of the Tax Reform Act of 1986, prepared by the Staff of the Joint Committee on Taxation, dated 7 May 1987, 74 Stand. *Fed. Tax Rep.* (CCH) No. 19, at 1016 (8 May 1987). But see Aud & Wright, "An Analysis of the Super-Royalty Provisions of the Tax Reform Act of 1986", 16 *Tax Management Int'l J.* 17, 21 (9 January 1987) (indicating that a "contract manufacturer" approach was likely to be adopted in some for in practice).
49. General Explanation of the Tax Reform Act of 1986, supra note 48, at 1012.
50. See generally Granwell & Hirsh, "The Tax Reform Act of 1986: The Super Royalty – A Step Forward or Backward?" 2 *Strategy Int'l Tax.* 375 (1986).
51. See H.R. Rep. No. 99-841, 99th Cong., 2nd Sess., II-638 (1986) (the so-called Conference Report).
52. I.R.C. §1491.
53. See I.R.C. §1492(2).

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II. U.S. TAX CONSEQUENCES OF OPERATIONS

A. Characterization of the entity for U.S. tax purposes

In determining the U.S. tax consequences of operating an Eastern European joint venture, it is first important to understand certain basic principles, among them the characterization of foreign entities for U.S. tax purposes, particularly as between a corporation and a partnership. This is actually a rather complex area of the law. In brief, the characteristics of a corporation are set forth in the U.S. Treasury Regulations promulgated under I.R.C. Section 7701(a)(2) and (3). They are:

(i) associates;
(ii) an objective to carry on business;
(iii) continuity of life;
(iv) centralization of management;
(v) limited liability; and
(vi) free transferability of interests.[54]

It is important to note that the classification under foreign law may be different than that under U.S. law.[55]

Since local law is likely to provide the attributes of centralization of management and limited liability regardless of the form the joint venture adopts,[56] flexibility in attempting to structure the investment as either a separate entity for U.S. tax purposes or a "fiscal transparency" akin to a partnership rests with limiting the free transferability of shareholder interest and the continuity of life should one of the partners drop out of the joint venture.

Generally speaking, it is most likely that foreign parties will subscribe to shares in a local company as part of the joint venture arrangements.[57] Nonetheless, local law may still permit sufficient flexibility to provide a choice in the structuring of the venture for purposes of U.S. tax consequences.[58]

In view of the rather strict repatriation rules which will apply, however, it is unlikely that U.S. companies will seek to structure their investments in the form of a partnership for U.S. tax purposes. Corporate vehicles will allow them to take advantage of a tax deferral until the income is actually repatriated. Otherwise there may be a U.S. tax on income from a partnership which is not actually received due to exchange controls, mandatory reserve requirements or the like.

B. Special topics in a corporate joint venture context

1. An important exception to deferral

Even if a joint venture is structured in the form of a corporation under corporate law and U.S. tax principles, it is possible that the proportionate share of the joint venture's income attributable to the U.S. shareholders may be attributed and deemed taxed to it pursuant to Subpart F of the I.R.C.[59] In effect, certain income which is derived by "controlled foreign corporations" is treated as having been constructively distributed to the "U.S. shareholders" (as specifically defined hereafter) thereof regardless of whether or not any distribution is actually made.[60]

The three primary types of income which may be "tainted" as so-called "Subpart F income" are foreign base company sales income, foreign base company services income and foreign personal holding company income.[61] Foreign personal holding company income consists mainly of "passive" income such as rents, royalties, interest and dividends.[62] Foreign base company sales and services income are defined, respectively, as income derived from sales between or services performed for "related" persons, where both the production and intended disposition of the property sold or purchased (or the services performed in the case of services income) take place outside of the "controlled foreign corporation's" country of incorporation.[63]

A "related" person may be either an individual, partnership, trust or estate which controls the controlled foreign corporation; a corporation which controls or is controlled by the controlled foreign corporation; or a corporation which is controlled by the same person(s) which control(s) the controlled foreign corporation.[64] There are a variety of exceptions as well as a de minimis rule which may be applicable in certain instances.[65]

54. Treas. Regs. §301.7701-2(a)(1). See generally Liebman, "United States Tax Treatment of Liechtenstein Anstalts: A Comment", 19 *Int'l Law.* 921, 922 (Summer 1985), and "Addendum", 20 *Int'l Law.* 1123-1125 (Summer 1986).
55. See 80-25 *Tax Management Mem.* 10 (15 December 1980).
56. See generally, e.g., Szasz, "Legal Aspects of East-West Joint Ventures: Legal Framework of the Economic and Foreign Trade System of Hungary and other CMEA Countries", 981/4 *Marketing Hungary* 5, 10-11; Scriven, "Joint Ventures in Poland: A Socialist Approach to Foreign Investment Legislation", 14 *J. World Trade L.* 424, 429-433 (September-October 1986).
57. See e.g. 26 *European Taxation* 113 (April 1986) (regarding the principle that a Czech joint venture should take the form of a corporate entity); Marciniuk, "Poland: New Legislation for Joint Ventures", 26 *European Taxation* 264, 265 (August 1986) (same). Cf. 27 *European Taxation* 59 (February 1987) (Soviet joint ventures will be juridical entities); Barnes, "Tsarist Law to be Used for Joint Venture with Finnish Company", *Fin'l Times,* 10 January 1987. See generally Liebman, "Comments on the Effects of Workers' Self-Management on Yugoslav Joint Ventures", 10 Md. *J. Int'l L. & Trade* 89 (Spring 1986); Zoubek, "Joint Ventures in East Europe", 9 *J. World Trade L.* 427, 431, 433-434, 438 (July-August 1975).
58. For example, even a limited liability company analogous to a GmbH could be structured as a partnership for U.S. tax purposes. See e.g. Rev. Rul. 77-214, 1977-1 C.B. 408. This would allow a Polish joint venture to be so structured as well as Bulgarian, Czech and Hungarian ventures, for example. Indeed, in certain Eastern European countries, the venture need not even be incorporated as a matter of domestic legislation.
59. I.R.C. §§951-964.
60. See generally Ortolani, Jr., "Operating Through a Foreign Joint Venture", in *U.S. Tax. of Int'l Operations* (P-H) para. 9529, at para. 9529.3 (16 July 1986).
61. I.R.C. §§952 & 954.
62. I.R.C. §§553(a) & 954(c)(2)-(4).
63. I.R.C. §954(d) & (e).
64. I.R.C. §954(d)(3).
65. For example, there is an exception for foreign corporations not used to reduced taxes in I.R.C. Section 954(b)(4) if the "U.S. shareholders" can prove that the foreign income was subjected to an *effective* rate of foreign tax equal to at least 90% of the maximum U.S. corporate tax rate. The de minimis rule has been amended by allowing the lesser of 5% of a "controlled foreign corporation's" gross income or one million U.S. dollars to constitute Subpart F income before its "U.S. shareholders" will be subjected to a tax on deemed income. I.R.C. §954(b). See generally General Explanation of the Tax Reform Act of 1986, supra note 48, at 990-991.

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The U.S. Tax Reform Act of 1986 has amended the statutory test of "control" for purposes of determining if a "controlled foreign corporation" exists. The test is now whether more than 50% of the voting power or value of the shares of stock is held by "U.S. shareholders".[66] Thus, it is certainly far from inconceivable that an Eastern European joint venture may constitute a "controlled foreign corporation" for U.S. tax purposes. This is especially so in those jurisdictions which, at least in theory, allow more than 50% equity ownership in the hands of the foreign joint venture partner.

Even prior to the 1986 amendments, the so-called "tri-test" of "actual control" had been applied by the IRS and upheld by the courts.[67] Under this test, the key element is the ability to exercise more than 50% of the voting power, such as by an ability to control the Board of Directors or day-to-day management, via implied agreements, by reason of the control over technology, and the like.[68] Hence although it will probably not be a problem in practice, attention should be paid to both the elements of control in the hands of the U.S. joint venture partner as well as the types of income which the joint venture will earn to determine whether Subpart F income may be triggered.[69]

2. U.S. foreign tax credits

Again, following the U.S. Tax Reform Act of 1986, the primary goal for most U.S. multinational corporations will be to maintain an overall effective foreign tax rate as low as possible and preferably down to the maximum U.S. corporate income tax rate of 34% following the 1987 transition year. On either direct foreign-source income such as dividends, interest or royalties received from a foreign company (including a joint venture) or on indirect income such as the underlying mainstream corporate income from which dividends are paid or the deemed receipt of income under Subpart F or other deeming provisions, the U.S. allows a direct and indirect foreign tax credit.[70] Credits are limited, however, to taxes paid on foreign-source income via a foreign tax credit limitation formula.[71]

As it is, many U.S. multinationals had already found themselves in an excess foreign tax credit position prior to 1986 in that their foreign effective tax rates were higher than their U.S. tax liability. This will normally be the case with Eastern European joint ventures as well since the tax rates in most socialist countries, especially taking into account any withholding taxes, are usually above the U.S. corporate tax rate.[72] The recent changes in U.S. tax law render this area even more complicated and difficult to plan for since they create a series of new separate "baskets" for calculating the limitation formula.[73] Although a three-year carryback and a five-year carryforward period are permitted[74], carryovers will prove useless if the U.S. company's overall foreign tax liability is not reduced further during the carryforward period so as to absorb its excess credits.

Basically the U.S. Congress' intent is to render it more advantageous on an after-tax basis to manufacture in the U.S. than to manufacture abroad. Unless Eastern European Governments take this into account, many U.S. companies will find it is prohibitively expensive (on an after-tax basis) to establish joint ventures in this region of the world.

C. Miscellaneous issues

1. Intercompany pricing rules

It is beyond the scope of this article to detail the U.S. provisions governing transfer-pricing between related entities. It is important to note, however, that the definition of related parties for this purpose need not entail any element of formal control.[75] Nor need there be any tax avoidance present in order to invoke the transfer-pricing provisions.[76]

Detailed regulations cover the sales of tangible products, intercompany loans, intercompany services and the licensing of intangibles. In general, it may be noted that the IRS seeks to insure that pricing between related entities takes place on an arm's length basis. In the case of sales of goods between a U.S. shareholder and an Eastern European joint venture, the IRS will generally seek to use one of the following methods for testing the group's pricing policies:

(i) the comparable uncontrolled price method;
(ii) the resale price method – being an uncontrolled resale price less a mark-up equal to the percentage of gross profit on uncontrolled transactions;
(iii) the cost-plus method, namely the product cost plus an acceptable gross profit margin; or
(iv) any other reasonable method.[77]

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66. In turn, being a United States person who owns, directly or indirectly, or is considered to own constructively, "10% or more of the total combined voting power of all classes of [voting] stock". I.R.C. §§951(b) & 958(b).
67. See Treas. Regs. §1.957-1(b)(2).
68. See e.g. *Koehring v. U.S.*, 583 F.2d 313 (7th Cir. 1978); *CCA, Inc.*, 64 T.C. 137 (1975), nonacq., 1982-1 C.B. 1. See generally Liebman, "Eliminating Current US Taxation", 6 *Tax Planning Int'l* 69 (April 1979); Liebman, "The Tax Treatment of Joint Venture Income Under Subpart F: Some Issues and Alternatives", 32 *Bus. Law.* 341 (January 1977); Liebman, "Taxation of Foreign Source Income: Implications of CCA, Inc.", 17 *Harv. Int'l L. J.* 335 (Spring 1976).
69. This is a complex area of the law and there are a variety of other definitions, thresholds and the like as well as other potential U.S. tax regimes (such as the foreign personal holding company tax, the accumulated earnings tax and passive foreign investment company provisions) which might possibly apply. A discussion of these provisions lies outside of the scope of this article. See generally Klein & Kaufman, "Passive Foreign Investment Companies", 16 *Tax Management Int'l J.* 223 (12 June 1987).
70. I.R.C. §§901 & 902.
71. I.R.C. §904.
72. See, e.g., 27 *Eur. Tax.* 161 (May 1987) (following a tax holiday period, joint ventures will be taxed at 30% in the Soviet Union; with a 20% withholding tax on foreign transfers, absent tax treaty relief, this yields a 44% effective tax rate); 26 *Eur. Tax.* 186 (June 1986) (the basic rate of Hungarian tax is 40% with tax relief available for certain operations; see also [January 1987] *Int'l Tax Rep.* 12). See also "Soviet JV Law: More Questions than Answers", 16 *Bus. Eastern Eur.* 41 (9 February 1987).
73. See generally McCawley, "Foreign Tax Credit – Qualification and Computation", 5 *Tax Management Weekly Rep.* 1300 (27 October 1986).
74. See I.R.C. §904(c).
75. Treas. Regs. §1.482-1(a)(3).
76. See, e.g. *Eli Lilly & Co. v. U.S.*, 372 F.2d 990 (Ct. Cl. 1967).
77. Treas. Regs. §1.482-2(e)(1)(ii).

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In the event that the IRS seeks to reallocate income to a U.S. party while the latter is precluded from receiving such income due to foreign exchange controls, there are certain provisions that may be invoked to provide temporary relief until the "blocked" funds can be repatriated under local law.[78]

2. Individual tax issues

One should also take into account the taxation of any U.S. expatriates to be sent to the joint venture on temporary assignment. There is currently an exclusion for US$ 70,000 of income of such expatriate employees if they meet certain conditions.[79] Applicable tax treaty rules may also play a role in planning for expatriate compensation.

3. Liquidations and reorganizations

In addition, it should be noted that any subsequent reorganizations or liquidations of the joint venture will be subject to special U.S. provisions. To the extent that the joint venture is indeed a "controlled foreign corporation" under Subpart F as discussed above, any sale or exchange of the shares of stock in that joint venture by the "U.S. shareholder" will be subject to tax at ordinary income tax rates as if a dividend were received.[80] As a result, the "earnings and profits" of the joint venture must be calculated in accordance with U.S. principles[81] to determine to what extent a dividend distribution may be taxed, with the remaining distribution being treated as either return of capital or a capital gain. Although there is no longer a difference between capital gains and ordinary income tax rates, there may nonetheless be a difference in terms of both the source of income for foreign tax credit purposes as well as the ability to carry along an indirect foreign tax credit, depending upon how the transaction is structured and then characterized under U.S. tax law.

4. Tax treaties

Finally, attention should always be paid to the impact of any relevant double taxation conventions, both with regard to withholding tax rates on interest, dividends and royalties as well as with regard to other provisions relating to individual employees, permanent establishment clauses, non-discrimination provisions, and the like.[82] It was most recently announced that the United States has resumed negotiations to sign a tax treaty with the Socialist Federal Republic of Yugoslavia, for example.[83] It would also appear that the Eastern European States in general continue to be active in negotiating such tax treaties and their provisions may often prove favorable for foreign joint venture partners.[84]

It may even be possible to engage somewhat in "treaty shopping" to find the most favorable treaty provisions when determining how (and through which countries) to structure an investment in a socialist country. The tax treaties with Eastern Europe are not yet so sufficiently sophisticated as to set out detailed anti-treaty abuse provisions. And, in general, the socialist countries have a good record of abiding by tax treaty provisions in accordance with their strict literal meaning.[85]

ADDENDUM

Technically, the deemed royalty provisions of I.R.C. Section 367(d) may be avoided by effecting an election to treat the transfer of an intangible to a foreign entity as a deemed sale. This can be accomplished (pursuant to the Temporary Treasury Regulations promulgated under this provision) in only certain circumstances, which include the transfer of an intangible in connection with the formation of a foreign joint venture.

This particular exception is only available, however, if certain stringent requirements are met, including:

(i) The transfer of the intangible within three months of the formation of the joint venture and as a part of its original capitalization;
(ii) Ownership by the U.S. transferor of between 40 and 60% of the voting power and value of the joint venture's share capital;
(iii) Ownership by *unrelated* foreign persons of at least 40% of the voting power and value of the joint venture's share capital;
(iv) The fair market value of the intangibles transferred must constitute at least 50% of the total property transferred by the U.S. transferor to the foreign joint venture; and
(v) The transfer of intangibles must be used for the active conduct of foreign business and not in connection with the manufacture or sale of the products in or for the use or consumption in the United States.

These conditions may be difficult to meet from a pure business point of view, and in any event, the passage of the "super-royalty" concept in the U.S. Tax Reform Act of 1986 may now render the applicability of this exception void. See Roth, "Tax Consequences of Technology Transfers to Foreign Joint Ventures", 4 *Computer Law.* 1, 8 (May 1987).

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78. See generally Liebman, "Allocations of Foreign Blocked Income Under United States Tax Law", 34 *Bulletin for International Fiscal Documentation* 251 (June 1980).
79. I.R.C. §911(b)(1)(A).
80. See I.R.C. §1248.
81. See I.R.C. §316.
82. See generally Bronwell & Johnson, "Tax Conventions with Poland, Romania and the U.S.S.R.", 8 *L. & Pol. Int'l Bus.* 763 (1976).
83. See *Daily Tax Rep.* (BNA) No. 69, at G-2 (13 April 1987).
84. See e.g. Miraillet, "New Swiss/U.S.S.R. Pact with Variations on OECD Model" [May 1987], *Int'l Tax Rep.* 9; Bakeš, "Czechoslovakia: Conventions on the Avoidance of Double Taxation", 41 *Bulletin for International Fiscal Documentation* 181 (April 1987).
85. Cf. Debatin, "The Role of Tax Treaties as Instrument of Economic Cooperation Between "Capitalist" and "Socialist" Countries", 39 *Bulletin for International Fiscal Documentation* 393 (August/September 1985).

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POLAND:

Tax Aspects of Joint Ventures with Western Companies Taking into Account Tax Treaties Concluded with Other Countries

By Prof. Dr. Jan Głuchowski

1. INTRODUCTION*

In the Polish tax system, as well as in the tax systems of all socialist countries, the essential distinctive feature is the division of the taxes between taxes on revenue in the socialized economy, the private sector and the population. The individual characteristics of these three taxes reflect the principles upon which the socialist State is based as well as the directions of the State's fiscal policies.

The Law on the taxation of the socialized sector of the national economy was passed by the Seym (Parliament) on 26 February 1982. The Law is of a comprehensive nature and constitutes a codification of the Polish financial law which concerns the subjects of the socialized economy. The list of taxable persons is very broad and includes: State enterprises and their organizations and associations; international or mixed enterprises; foreign legal entities operating in Poland on the basis of specific international agreements; banks (with the exception of the Polish National Bank); institutions of higher education and research institutes; cooperatives and their associations; companies of various legal natures; and political, social and professional organizations.

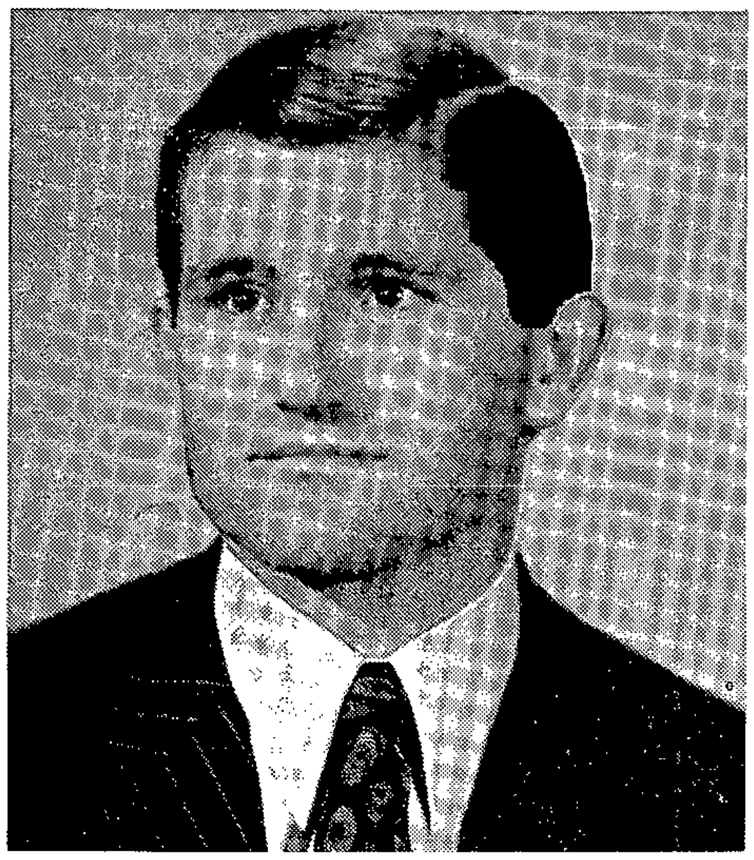
The basic taxes levied from the above-mentioned subjects in a socialized economy are: turnover tax, wage bill tax, real estate tax and income tax. The law provides for the possibility to raise additional taxes, reserving the right to do so to the Council of Ministers. The taxable entities in the socialized sector are registered with the competent taxation office and are obliged to calculate and pay all taxes within the prescribed time without a special summons.

The private sector of the economy is divided for taxation purposes into two parts: private farms and all other remaining private firms. Private farmers pay a land tax and, additionally, an equalization tax and must contribute to the so-called local fund.

All other private firms pay income tax. Taxes on the means of production (for example real estate tax) are of minor importance. Income is taxed in the classical way. At the first stage is the turnover tax which is a form of preliminary tax. At the second stage is the proper income tax which is levied when the taxpayer makes a profit, in other words, when the income exceeds the costs including the already paid turnover tax. The turnover tax is a flat rate tax and the income tax is a progressive one.

Very small private firms are not taxed in accordance with the general principles (turnover tax plus income tax), but are subject to a simplified system whereby there is no need to maintain books of account for taxation purposes. These simplified forms of taxation include: a contractual lump-sum tax; a cooperative lump-sum tax; a taxation card; and the licence fee. Under this system the State has the advantage of eliminating the cost of tax assessment, while the taxpayer has the opportunity to increase income without increasing tax liability.

The population pays a tax on wages and salaries – if employed in the private sector or if receiving salaries from two employers – an equalization tax, an income tax, and a tax on inheritances and donations. Furthermore, there are local taxes, namely, a real estate tax, a tax on premises and a tax on pet dogs.



Jan Głuchowski graduated from Gdańsk University, Faculty of Economics in 1962. From 1962-1965 he held an appointment as an assistant in the Faculty of Law at Copernicus University where he received his Ph.D. in Law in 1965. In 1966, Professor Głuchowski became an Assistant Professor at Copernicus University and in 1977 he was granted a full professorship. He has been Dean of the Faculty of Law (1976-1978) and is now Vice-President of Copernicus University. Professor Głuchowski has been a visiting professor at the University of Michigan (1971-72), Moscow Financial University (1975), and the Friedrich Ebert Stiftung, Bonn (1985-1986). He has published many articles including: *Federal Taxation System of the U.S.A.* (1975); *International Legal and Financial Relations of the Socialist Countries* (1984); and *International Financial Law* (1987).

* See for a survey of the Polish taxation system *Guides to European Taxation: Volume V, Taxation in European Socialist Countries,* published by the International Bureau of Fiscal Documentation.

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2. THE 1982 LAW[1]

The Act of 6 July 1982 (Principles of Conducting an Economic Activity in Small Industry in the Territory of the Polish People's Republic by Foreign Juristic and Physical Persons) codified most of the rules governing such activities. The Act was amended in the Income Tax Act of 28 July 1983.

The 1982 Act regulates the economic activity by small industrial concerns conducted in Poland by foreign investors individually or jointly with Polish partners. Art. 1, § 2 provides that investors may conduct economic activity in their own name and on their own account or may enter into a partnership or form a company with Polish partners. In the latter case, legal regulations do not require the Polish partner to be the majority shareholder.

According to Art. 1, § 1 foreign investors or economic units may be: juristic and natural persons having their residence or seat of business abroad as well as foreign nationals granted a charter of residence in Poland. The Act distinguishes two categories of enterprises: "foreign enterprises" belonging exclusively to foreign investors and "enterprises with foreign participation", i.e. "companies in which foreigners participate in Polish economic units" (Art. 5, §3). The Act enumerates the "Polish economic units" which may be partners with foreign investors. They are: small State industrial enterprises, social organizations authorized by specific regulations to carry on economic activity, cooperatives, producers' associations and domestic partnerships carrying on activities under provisions concerning the production of handicrafts or other goods jointly with foreign economic units (Art. 5, § 1).

In order to conduct economic activities in Poland, the foreigner must have a special permit which is granted by the local administrative authorities. Exports and imports require an additional permit granted by the Minister of Foreign Trade. Art. 9 of the Act enumerates the information required on an application for such a permit. An application for a permit for establishing an enterprise with foreign participation must be submitted jointly by all the partners. A further requirement is the depositing of the equivalent of 800,000 to 4,000,000 zloties in foreign currency with a Polish bank (i.e. about US$ 4,000 to 20,000) depending on the size of the envisaged enterprise. This deposit serves as a security for any legal claims that the Polish economic units may have as a result of the non-performance of the foreign investors.

The deposit is released when the enterprise becomes operative. The permit is granted for a twenty-year period. It may be granted for a longer period where the period of depreciation of the investment is longer.

Polish law permits foreign investors, as well as their Polish partners, to choose the legal form of their enterprise. They may elect one of the three forms of commercial companies provided for in the 1934 Commercial Code:

- a registered partnership;
- a private limited company; or
- a public limited company.

The 1982 Act does not require a majority participation of Polish capital. According to Art. 14, however, in cases justified by an economic or social interest, the granting authority may require an interest in the enterprise with foreign participation of certain Polish economic units to exceed 50%. The private limited company form appears to be best-suited to the needs of foreign investors in small industry. It is easier to be established and its organization is much more simple than that of a public limited company.

The property of a foreign enterprise is composed of foreign investment contributions which may consist in fixed and liquid assets, acquired with convertible currencies or for zlotys received through documented exchange operations. Patents, licences and other similar rights may also constitute an investment contribution. The share of a Polish citizen domiciled in Poland may be comprised of his own fixed and liquid assets as well as licences or patents. He may also obtain a permit under the foreign currency regulations to enable him to contribute a share paid for in foreign currency owned by him.

The financial system of foreign enterprises was established by the Decree of the Minister of Finance of 12 November 1983 concerning Foreign Currency Permits for Foreign Enterprises and Enterprises with Foreign Participation. It determines the scope of foreign investors' rights to possess and to dispose of foreign currency and Polish zlotys. The internal system of foreign enterprises revolves around a number of different funds which are utilized to meet both international and external expenditures. Under the applicable fiscal regulations the foreign enterprises are to maintain bank accounts in both zlotys and foreign currencies.

Foreign investors may annually transfer abroad a part of their profit in the amount of: (a) 10% of the value of their investment contribution in convertible currency and (b) 50% of the surplus of income in convertible currency from exportation over expenditures for importation, after fulfilling the obligation to sell the remaining 50% of this income to a Polish foreign currency bank. This is provided that the total amount transferred abroad on these grounds does not exceed 50% of the income earned during the previous accounting year after the deduction of the income tax.

Foreign investors conducting economic activities in Poland are subject to Polish turnover and income tax.

Turnover tax charges result from the provisions of the Turnover Tax Act of 16 December 1971 (unified text of 29 July 1983). Income tax derives from the provisions of the Income Tax Act of 16 December 1972 (unified text of July 1983). The Income Tax Amendment Act of 28 July 1983 repealed the specific rules

1. See: Jerzy Rajski, "Le nouveau régime juridique des petits investissements étrangers en Pologne", *Journal de Droit des Affaires Internationales*, No. 2, (1985).

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concerning taxation which were contained in Arts. 26-28 of the Foreign Small Investment 1982 Act. Turnover tax rates are proportional and vary depending upon the type of economic activity. First, they are fixed by the Regulation of the Minister of Finance of 29 July 1983 on the Turnover Tax Rates on Turnover Resulting from the Economic Activity Conducted in the Territory of the Polish People's Republic by Natural and Juristic Persons Having their Domicile, Residence or Seat Abroad and by Foreigners Having a Resident's Card in Poland. The general tax rate is 10% in respect of turnover from commercial and service activities. However, special tax rates have been established in relation to a number of economic activities, ranging from 1% (e.g. baker's products) to 85% (e.g. the sale of raw coffee grain).

Income tax rates are progressive and range from 20% to 85% of the profits. The Regulation of the Council of Ministers of 29 July 1983 provides for lower income tax rates and even exemption in certain cases.

The foreign investor may sell its enterprise or his share in the enterprise after obtaining a currency permit. The sale contract has to be concluded in the form of notarial document and the purchaser must have a permit for operating such enterprise. The amount received from the sale is to be paid in convertible currency to the Polish bank. The seller which fulfils these conditions as well as its tax obligations may transfer the sales proceeds abroad.

3. THE 1986 ACT

Poland has two different classes of business enterprises: State enterprises and companies with foreign participation. Taxation of both is regulated by law. To cover various necessary differences in both taxation and general regulation of these two classes of companies there were two choices: (1) create a taxation system for foreign participating companies or (2) modify the existing system. The second choice, that of modification, was chosen. This avoided having to enlarge and complicate the Polish taxation system and taxation law. It was accomplished by the Act of 23 April 1986. Basic rules are contained in Chapter IV, Arts. 19-26.

Arts. 19 to 23 define ways of forming a company and dividing the profits. They also include the principle of how profit distributed in foreign currency may be used. Arts. 24 to 26 include guidance regulations concerning bank credit, settlement of accounts, and foreign currency.

The gross profit of the company is greatly affected by and dependent on the rates of depreciation of investment. Sec. 19 sets the rate which is the same for both State and foreign companies. There is one difference: a State enterprise must transfer part of this depreciation to the State Budget. Foreign participation companies may retain all of it.

This is a proper and justifiable difference. From the point of view of foreign partners any sharing of depreciation with the State Budget would be an additional form of taxation of investment. Such funds are usually not taxed in Western countries.

Distribution of a company profit is made in three stages. First, it is necessary to pay income tax (this will be discussed later). A second requirement is payment into a reserve fund. This is a fund to cover possible future losses. It is an obligatory payment at the rate of 10% of profit. If the level of the fund is 4% or more of the total costs of the company for the year, no further payment to this fund is required. The third stage of distribution of profit is payment to the partners, in proportion to their share in the capital of the company. Sec. 5 of Art. 19 allows partners, with the agreement of the Minister of Finance, to agree on other rules of profit participation.

Foreign partners may use their profit to increase the capital fund of the company (Art. 23, Sec. 1). In doing so, it is necessary to take into account the limits formulated in Arts. 5 and 8.

Art. 8 states that Polish partners must be owners of 51% of the shares in a company with foreign participation. If the Minister of Foreign Trade, in cooperation with any other involved Minister, determines that it will not be against the security of the State, he may authorize a variation from this rule.

It is worth mentioning that regulations do not say anything about Polish partners using their profits to increase the company's capital fund. This means that the only condition required would be consent of the remaining partners.

Each year a company must present a balance sheet showing the year's profit or loss. This must be approved by the Minister of Finance or an institution such as the Chamber of Treasury authorized by the Minister of Finance (Art. 20, Sec. 2). The legal regulations concerning profit and loss statements of companies with foreign participation are the same as those applicable to State enterprises.

When a company receives foreign currency from export sales, the Act of 1986 creates an obligation for it to sell a portion of this foreign currency to the Polish State Bank. When the Minister of Trade, in agreement with the Minister of Finance, grants permission to create a company a quota of obligatory sales of foreign currency receipts is set for the company. This is set separately for each company and ranges from 15 to 25% of foreign currency income received.

If economically justified, as by need for buying imported raw materials or goods, the percentage required may be lowered to allow the company sufficient foreign currency for its needs (Art. 21, Secs. 1 and 2). After the obligatory sale of foreign currency to the State, the company may dispose of the remainder (Art. 21, Sec. 3). This portion may be shared among partners in proportion to their participation in the capital fund (Art. 22, Sec. 3).

When the foreign partners receive a distribution of

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foreign currency, they may transfer all of it abroad without permission.

Polish partners are partially limited in their disposal. The Minister of Foreign Trade has the power to decide what sum may be used freely by them. The rest of their foreign currency is to be sold to the State Bank (Art. 22, Sec. 3).

A further issue in the distribution of foreign currency to pay profit is the type of foreign currency to be used. Art. 22, Sec. 4 specifies that it is to be the same currency type as was received. It is my opinion that if income is received in several different currencies any profit distribution will be paid proportionally in those different currencies.

Some remaining points concerning general financial regulations of a company with foreign participation as covered in the Act of 1986 are:

1. The company has a right to open accounts in Polish or foreign banks; the latter only after receiving permission from the Polish State Bank.
2. It is possible to obtain commercial credit.
3. The Polish State Bank in which the company has its account guarantees the obligations of the company.
4. Foreign currency may be used in Poland to pay for goods and services.

Taxation of State enterprises and those companies with foreign participation is covered by the Act of 1982. Under this Act both types of company pay income tax, turnover tax, property tax, payroll tax, and excess payroll tax. Differences in taxation of the two types concern only income tax.

The taxable base for a company is the verified income received during the year (Art. 30, Sec. 1). This may be adjusted for so-called excessive costs and losses; as for instance, unduly large administrative costs. These adjustments play a positive role in the economy of State enterprises, but would certainly be questioned and found unattractive by foreign investors.

Rates of income tax are quite naturally a very important and decisive factor for foreign investors. The rate level has to be set to protect the fiscal interest of the State, while at the same time not creating barriers to foreign investment. It is an important competitive factor since companies with foreign participation and opportunities to invest in them exist in many socialist countries.

The income tax rate for foreign participation companies is set by Art. 30, Sec. 2, at 50% of the income base. This is 15% lower than that for State companies (65%), but higher than in other Eastern European countries.

A very important variation of this tax rate is included in Sec. 2, which concerns export income. For each 1% of income derived from exports, the tax rate is lowered by 0.4%. In the extreme case that all income of a company was derived from exports, this provision would reduce the tax rate to 10%.

Two other exemptions are included in Art. 30. First, companies are not taxed in their first two years of activity. Second, sums used for investment are not taxed.

Other tax reductions are connected with investments in environmental protection, insurance for labour and reduction in imports (see: Decree, Council of Ministers, 27 December 1983, Tax Reductions in Income Tax).

It's worth mentioning two last problems. The turnover tax does not burden goods and services which are sold abroad by State companies as well as by foreign participation companies (Art. 18, Decree of 1983). The other issue concerns payroll tax. People consider that companies with foreign participation should be free to decide and implement the level of salaries of their employees.

Two other obligatory payments interrelated with taxation of companies (Act of 23 December 1985) are the "Fund to Service Foreign Debt" and the "Fund to Develop Science and Technology". Both foreign participation companies and State enterprises must pay 2% of the value of buildings and machineries per year to the first fund. Payment to the second fund is required only in the case of Polish partners owning over 50% of capital stock. The amount of the payment is defined annually in the central social-economic plan.

4. TAX TREATIES

From the point of view of their contents the bilateral agreements on the prevention of double taxation signed by Poland can be divided into three categories: (a) agreements aimed at preventing double taxation of income derived from shipping and air transport; (b) agreements aimed at preventing double taxation of incomes; and (c) agreements aimed at preventing double taxation of income and assets. The contents of the agreements depend on the problems they deal with. The shortest are those dealing with the prevention of double taxation of income derived from shipping and air transport. Poland concluded such agreements with the People's Republic of China, Switzerland, Greece and Italy.

Agreements on the prevention of double taxation of income were concluded with Japan, Malaysia, Pakistan, Thailand and the U.S.A.

Finally, agreements on the prevention of double taxation of income and assets were signed with Austria, Belgium, Denmark, Finland, France, Norway, Spain, Yugoslavia, the Netherlands, the Federal Republic of Germany, Sri Lanka, Sweden and the United Kingdom.

As a rule, the bilateral agreements signed by Poland contain the following basic provisions.

Income from real estate, including income from the exploitation of farms and forests, is taxable in the country where the real estate is located. The term

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"real estate" is interpreted according to the law of the country of location.

Income from enterprises can be taxed only in the country of location, unless they operate in another country through their branches. In that case, income derived from the operation of that branch is taxable also in the State where it operates. An enterprise maintaining an office in another State with a representative authorized to conclude agreements and contracts on its behalf, is deemed to have a branch office in that State.

Dividends are taxable in both States, with the proviso that the tax levied in the State where the company paying the dividends is located cannot exceed a percentage fixed in the agreement. Interest on loans can be taxed in both States concluding an agreement on the prevention of double taxation.

Licence fees and income from copyrights, patents, sale of know-how, trade marks, motion picture distribution rights and use of recordings by radio and television can be taxed only in the State of residence of the person deriving such income. Hence, no taxes can be levied on such income in a State where that income originates. However, some of the agreements signed by Poland contain exceptions from that rule, provided that the tax cannot exceed 10% of gross income.

The agreements on the prevention of double taxation single out the professions, which include, in particular, scientific, literary, artistic and educational activity. However, the term "professions" also includes physicians, lawyers, technicians, engineers, architects and dentists. The income of these people is taxable only in their State of residence, but if such a person exercises an activity in another State and disposes in that State of proper facilities, then his or her income can be taxed in that State.

Wages and salaries can be taxed in the State of residence of the taxpayer. However, if the person works on the territory of another State and derives income from that work, he or she can be taxed in that State. Income of members of excecutive and supervisory councils of companies are taxable in the State of residence of the company. The agreements provide for a general tax exemption for students and professors engaged in research and lecturing. Other not mentioned income is taxable in the State of permanent residence of the person deriving such income.

JOINT MEETING OF BRITISH AND SWISS BRANCHES

In Bulletin 1987/4, p. 180, mention was made of the meeting of the British and Swiss IFA Branches on 21 and 22 May 1987 in Lucerne (Switzerland). Both the individual subjects treated and the names of the lecturers were listed in this Bulletin.

The meeting discussed a number of the most crucial aspects of cross border transactions between Switzerland and the U.K., including the use of foreign base and offshore companies, the implications of corporate residence rules and the U.K. controlled foreign company provisions, the growing problem of the impact of anti-treaty abuse provisions on the use of double taxation treaties, and all of the circumstances where the two countries consider that hidden distributions of profits have occurred. There was also a comprehensive discussion on the exchange of information and mutual assistance between governments in relation to the administration of tax law and the extra-territorial application of laws.

The meeting was attended by over 100 tax specialists from the two countries and was particularly notable for the lively and in-depth discussions of the topics considered. The opinion prevailed that such meetings should be scheduled on more frequent occasions in future.

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YUGOSLAVIA:
Relevant Aspects in Tax Laws and Treaties Concerning the Taxing of Foreign Persons

By Miodrag Arsić

I. CONDITIONS FOR AND MANNER OF FOREIGN PERSONS INVESTING IN DOMESTIC ORGANIZATIONS OF ASSOCIATED LABOUR AIMED AT JOINT BUSINESS

Yugoslavia, like other countries, is interested in investments in domestic organizations of associated labour[1] for the purpose of ensuring a broader and longer-term inclusion in the international division of labour, procuring modern technologies, increasing exports and the supply of the domestic market, reducing imports and furthering the work and business of domestic organizations.

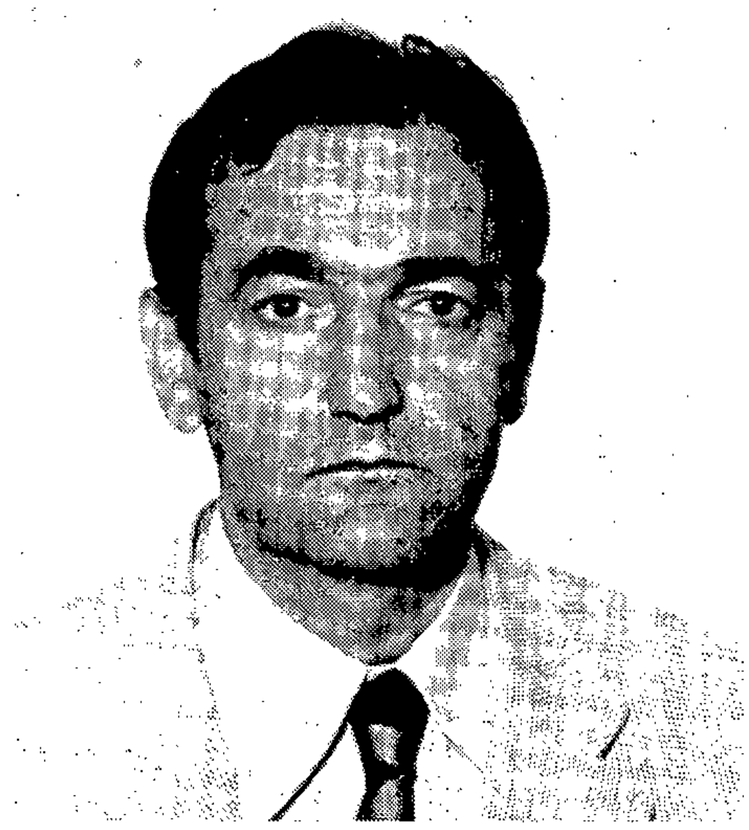
According to the Law on Investment of Resources of Foreign Persons in Domestic Organizations of Associated Labour (Official Gazette of the SFRY, No. 5/85) such investments are possible provided the following conditions have been met:

- that a foreign person invests resources in a domestic organization of associated labour with a view toward realizing joint business objectives and interests (joint business);
- that resources have been invested with joint risk and that their return depends on joint business results;
- that a foreign person decides on the issues relevant for joint business in agreement with a domestic organization of associated labour; and
- that a foreign person is entitled to his share in income realized through joint business in the framework of which he exercises the right to the return on the value of invested resources and to compensation on account of doing business with these resources.

Mutual relations between contracting parties arising from joint business are regulated by a contract on the investment of resources which must be concluded in writing and approved by a federal administrative body competent for energy and industry affairs.

The investment contract particularly regulates:

- the objective of investment of the resources, purposes, conditions and mode of utilization;
- the total amount of needed resources to be invested in light of the joint business, the breakdown of this amount into resources invested by a domestic organization of associated labour and those invested by a foreign person;
- the manner to determine the part of income in whose formation a foreign person participates which will belong to the domestic organization;
- the bases and principles for determining the foreign person's share in the income of a domestic organization;
- the mode of, conditions and terms for the payment on account of a foreign person's share in income of a domestic organization of associated labour;
- the mode of, terms and condition for the return of value of the resources invested;
- the mutual obligations of contracting parties in case of losses incurred through joint business as well as other obligations on account of risk sharing;



Mr. Miodrag Arsić, graduate of the School of Laws, working in the Federal Secretariat of Finance as a Head of the Tax Treaty Department. Member of the International Law Association of Yugoslavia. Published a number of articles dealing with the tax system of Yugoslavia and double taxation.

1. The term "associated labour" is used to denote all institutional forms of labour associations through which workers, organized on a self-management basis, perform economic and non-economic activities with socially-owned resources, as well as to denote all other forms for pooling of labour and resources by working people. See *Guides to European Taxation: Vol. V, Taxation in European Socialist Countries*, Chapter Yugoslavia, 6.1.1.

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- the composition and competences of a joint business board and mode of its election; and
- the manner for settlement of mutual disputes.

The share of a foreign person in income realized through joint business is proportionate to the contribution made in realizing this income on account of invested resources.

A domestic organization obtains the income earned through joint business after material and depreciation costs have been taken from gross income realized through joint business with a foreign person.

The obligations and outlays regulated by law and settled from income of a domestic organization (related with realization of income) are covered from the income realized through joint business with a foreign person.

Part of the net income arising from joint business with a foreign person is used to finance personal incomes and collective consumption of workers. The remainder is allocated to:
(1) the domestic organization; and
(2) the foreign person (profit) proportionate to the resources invested or other criteria set forth by contracting parties.

Part of the remainder of net income arising from joint business and belonging to a foreign person accounts for his share in income on account of compensation for the business activities performed with invested resources in the year for which net income from joint business is determined.

A foreign person is entitled to transfer abroad resources earned through joint business on account of income sharing, in keeping with the Law on Foreign Exchange Operations and Foreign Credit Relations.

A foreign person may use resources which he is entitled to transfer abroad to increase his participation in the resources of the joint business or may conclude a contract providing for the investment of such resources in another organization of associated labour, or he may use such resources in Yugoslavia in some other way, in accordance with the law.

II. RELEVANT ASPECTS FOR TAXING FOREIGN INVESTORS IN THE YUGOSLAV TAX LAWS

In accordance with the Constitution of Yugoslavia, direct taxes paid by domestic and foreign juridical and physical persons are regulated by the respective laws of the republics and autonomous provinces. With a view of eliminating significant differences and/or harmonizing the tax system and tax policy bases, on 28 December 1984 the republics and autonomous provinces concluded:
- the Agreement on Tax System Harmonization; and
- the Agreement on Tax Bases Policy.

The Agreement on Tax System Harmonization envisages that the republics and autonomous provinces, in taxing the profit arising from investments of foreign persons, will introduce a tax on the profit of foreign persons earned on account of resources invested in a domestic organization of associated labour.

By the provisions of both Agreements the republics and provinces agreed and/or committed themselves to regulate basic elements of this tax as follows:

Taxpayer. The taxpayer, on account of the profit of a foreign person realized through investing resources in a domestic organization of associated labour, is a foreign person who on the territory of Yugoslavia earns profit through joint business.

Tax base. The tax base forms a part of the remainder of net income earned through joint business which belongs to a foreign person (profit) proportionate to the resources invested or other criteria set forth by the contracting parties.

Tax rate. The tax rate is proportional and equals 10%.

The republics of Bosnia and Herzegovina, Montenegro, Serbia, Slovenia and the autonomous province of Vojvodina accepted this rate in their respective laws on taxing foreign persons. The following republics and the autonomous province of Kosovo have not as yet accepted the rate. Their actual rates of taxing foreign persons are:

Croatia	35%
Macedonia	14%
Kosovo	20%

It should be noted that in Croatia the tax on resources invested in catering and tourism is paid in the first 5 years at the rate of 5% and in the following years at the rate of 20%. In Kosovo, the tax rate drops from 20% to 10% if a foreign person invests resources in a domestic organization of associated labour in an economically less developed region of the province.

Tax facilities (exemptions). If a foreign person reinvests or deposits a part of the profit earned on account of resources invested in a domestic organization of associated labour with a bank, he is fully exempted from tax payments on account of the part of the profit reinvested or deposited.

The republics and provinces have also committed themselves to prescribe that international corporations with investments in capital in a domestic organization of associated labour in Yugoslavia and international organizations exempted from tax payments on the grounds of international treaties will be exempt from paying tax on the profit earned on the territory of Yugoslavia for the resources invested as a part of these corporations' share in income realized through joint business, proportionate to the share of resources held by these corporations in the organization of associated labour to total capital (potential).

Bosnia and Herzegovina, Montenegro, Slovenia and Vojvodina have, by their respective laws on taxing foreign persons, accepted the solution envisaged by

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the aforesaid Agreements and have decreed that a foreign person which reinvests in a domestic organization or places deposits with a bank of a part of the profit earned, is exempted from the profit tax in proportion to the part of profit invested and/or deposited.

However, this step has not yet been undertaken by the republics and the province of Kosovo listed in Table I, so that tax facilities for reinvested or deposited profits, as envisaged by their laws on taxing foreign persons, are as shown in that table.

Table I

Republic or province	Reinvested or deposited profit (%)	% of facility for reinvested or deposited profit
Croatia	at least 20	10
	for each % above 20	0.5
Macedonia	at least 25	20
	from 25-50	40
	above 50	60
Serbia	at least 25	15
	from 25-50	30
	above 50	50
Kosovo	at least 30	30
	from 30-50	50
	above 50	70

The above republics and the autonomous province of Kosovo are soon expected to bring their tax rates and tax facility provisions into accord with the solutions envisaged in the above Agreements with a view of fully ensuring a uniform tax treatment of profit earned by foreign persons in Yugoslavia, irrespective of the republic or autonomous province where investments are made.

The republican and provincial laws envisage that, if a foreign person transfers with compensation its rights and duties from the contract on investments of resources for joint business to a domestic organization in which he invested a part of profit earned (reinvested) or to another organization, prior to the expiration of a 5-year period from the date the profit was invested, the foreign person shall lose the entitlement to the tax facility. In such a case the tax shall be subsequently levied up to the full amount. Should a foreign person proceed in the above explained way after the expiration of the 5-year period, but not sooner than 10 years from the date of investment, he shall lose entitlement to 50% of the tax facility.

Tax levy and collection

A domestic organization of associated labour in which foreign resources were invested for joint business is liable to separately show in its annual balance sheet the income earned through that business as well as data relevant for determining the profit of a foreign person. It is also liable to calculate and pay, on account of a foreign person, tax on profit within specific terms. Generally, a domestic organization is obliged to make monthly advance payments of the tax on profit of a foreign person which equals 1/12 of the tax paid on the profit earned in the preceding year. The domestic organization and the foreign person are joint guarantors for the non-paid or not timely paid tax on profit of the foreign person and in such cases they are subject to additional tax payment of 0.1% daily of the non-paid tax amount.

The Social Accounting Service has been entrusted to supervise calculation and payments of the tax on profit of a foreign person. A foreign person enjoys legal protection against rulings passed by the Social Accounting Service in connection with the levy and collection of tax for 60 days from the day such ruling is received.

The right to levy and collect the tax on profit of a foreign person expires with the 5-year period's expiration, beginning on the date the tax collection was due. At the same time, the right of a foreign person to request that the profit tax incorrectly levied or excessively paid be refunded, expires with the expiration of the 5-year period from the date when such request had to be presented.

III. RELEVANT ASPECTS FOR TAXING FOREIGN INVESTORS IN DOUBLE TAX TREATIES

In addition to unilateral favourable measures relating to profit taxation on account of resources invested in domestic organizations of associated labour envisaged in the republican and provincial laws on taxing foreign persons, it is a great interest of Yugoslavia to internationally ensure, by concluding bilateral treaties, avoidance of double taxation of such profits with a view toward encouraging foreign investors to invest in Yugoslavia.

To date, Yugoslavia has concluded treaties for the avoidance of double taxation in connection with income and property taxes for this purpose with the countries mentioned in Table II.

Table II

Country	Object	Implementation started in:
France	income	1976
Belgium	income and property	1982
Sweden	income and property	1982
Denmark	income and property	1983
the Netherlands	income and property	1983
the United Kingdom	income	1983
Czechoslovakia	income and property	1984
Italy	income and property	1986
Norway	income and property	1986
Poland	income and property	1986
Cyprus	income and property	1986
Sri Lanka	income and property	1987

Moreover, treaties for the avoidance of double taxation of income earned in international sea and air transportation were also concluded with the People's Republic of China, Greece and Switzerland.

In addition, the ratification procedure of the treaties

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with the countries listed below is currently underway:

Hungary	Romania
Finland	Federal Republic of Germany

The signing of treaties is soon expected to take place with Canada and Egypt, since negotiations have already been carried out.

Also, negotiations between Yugoslavia and 30 countries for the avoidance of double taxation are in different stages. It is thus expected that the number of concluded treaties shall soon substantially increase.

The treaties concluded so far or those in the process of negotiation at the level of delegations (the texts of treaties are either signed or initialled) incorporate in Articles referred to below, respective tax treatment management provisions for foreign persons' profit earned on account of resources invested in domestic organizations of associated labour:

Art. 2 (treaty applied taxes)

Paragraph 3 of this Article explicitly stipulates that in the case of Yugoslavia the treaty applies to the tax on profit of a foreign person on account of resources invested in a domestic organization of associated labour, as its nature is of an income tax type.

Art. 7 (income arising from doing business)

This Article stipulates in treaties signed with all countries, with exception of France (the first general agreement on avoiding double taxation is concluded with this country), contains a provision envisaging that "profit earned in Yugoslavia by a resident of a respective country on account of resources invested in a domestic organization of associated labour may be taxed in Yugoslavia" or the provision regulating that "the provisions of Art. 7 of the treaty shall be applied on profit earned in Yugoslavia by a resident of the respective country on account of his participation in joint business with a Yugoslav enterprise".

The above provisions are aimed at ensuring:

- that a foreign person's Yugoslav-source profit on account of investments made in a domestic organization be treated, in view of specific features of the Yugoslav economic system, as income realized through business activities of an enterprise in keeping with Art. 7 of the treaty and not as a dividend (in line with Art. 10 of the treaty),
- that Yugoslavia is vested with the right to tax such profits of a foreign resident, irrespective of the fact whether he has a permanent establishment on the territory of Yugoslavia to which the profit would be attributed.

Art. 10 (dividends)

The treaties signed by Yugoslavia after 1983 define in paragraph 3 of this Article the term "dividend" in a manner which clearly indicates that it does not take account of the profit earned in Yugoslavia by a resident of the country – party to the treaty – on account of resources invested in a domestic organization of associated labour.

This solution is directly linked with the specific provisions of Art. 7 of the treaty with a view of emphasizing specific characteristics of the Yugoslav economic system in which no possibility for the realization of dividends exists.

Art. 23 (double taxation avoidance method)

The issue of the double taxation avoidance method in the treaties for the avoidance of double taxation with Yugoslavia, accepted by Contracting States for residents who earn profit in Yugoslavia on account of investing resources in domestic organizations of associated labour, is one of the most important issues for Yugoslavia whose inadequate solution cannot lead to conclusion of the treaty. The underlying reason is that only by way of applying an appropriate method to the stimulative effects of the Yugoslav tax facilities, approved in the case when a resident of the other Contracting State reinvests or makes a bank deposit of his profit (a part of profit) earned through joint business, it can be ensured and preserved with a view of attracting foreign investments to Yugoslavia. Such a positive effect of the treaties is precisely one of the basic motives for their conclusion, particularly with the capital exporting countries.

With the *exemption method* application, Yugoslavia has ensured in the treaties signed with the countries listed below that the profit earned by their residents in Yugoslavia on account of investing in domestic organizations for the purpose of joint business be exempted from the taxable base in those countries:

France	Poland
Belgium	Egypt
Czechoslovakia	Federal Republic of Germany
the Netherlands	Romania

With the application of the *tax spared credit method* Yugoslavia has provided in its treaties signed with the countries quoted below that these countries allow for deduction from their residents' taxable amounts not only the tax profit amount they actually paid in Yugoslavia, but also the tax amount not paid on account of tax facilities granted when a part or entire amount of profit earned through joint business is reinvested or deposited with a bank:

Sweden	Cyprus
Denmark	Sri Lanka
the United Kingdom	Canada
Norway	Hungary
Italy	Finland

The treaties signed with Sweden, Denmark and Norway envisage that the tax spared credit method be applied in the first 10 years, starting from the date the application of the treaties starts, and the need that competent organs of the Contracting State carry out consultations with a view of taking the decision to extend this period. The treaty signed between Yugoslavia and Finland stipulates that the said period last 5 years with a possibility of its extension subject to consultations between competent authorities.

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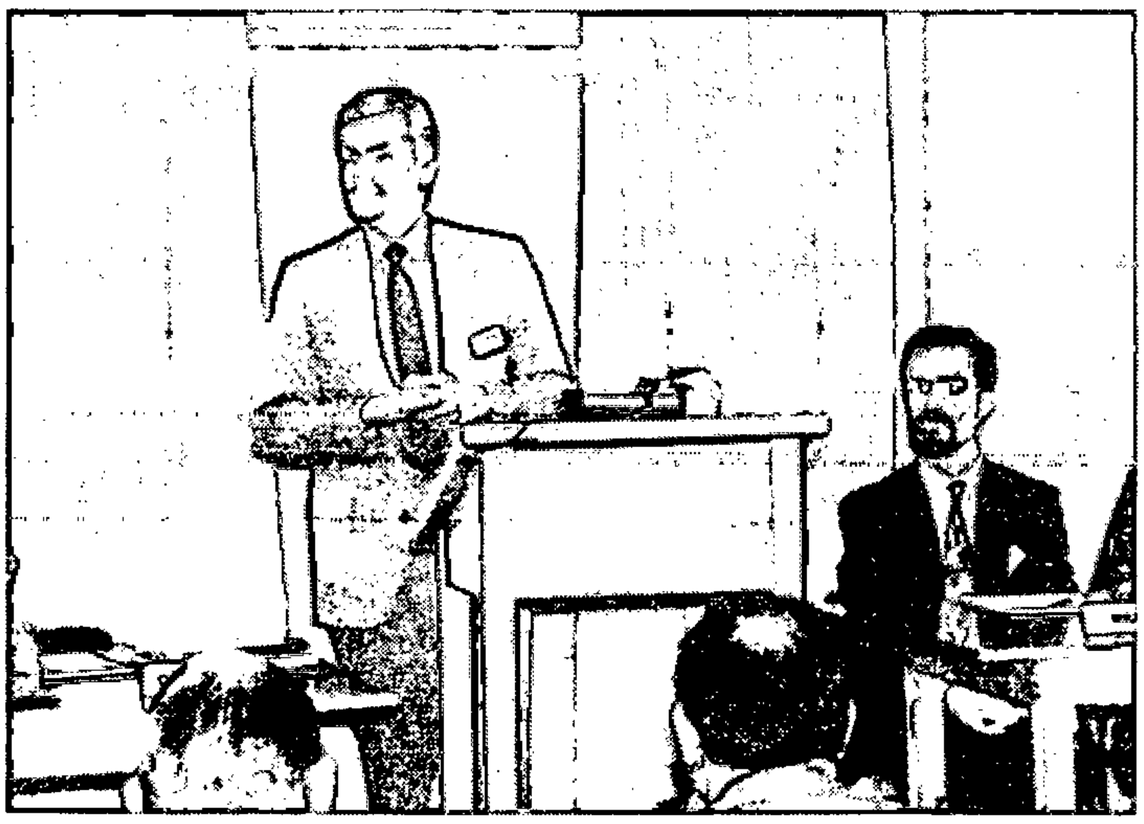
The treaties signed with the United Kingdom and Canada stipulate that tax spared credit cannot be allowed after the expiration of the 10-year period, from the date when the tax facility was granted for the first time to their resident on account of reinvesting or depositing the profit. However, the treaty signed with Canada envisages the possibility that competent authorities may agree on an extension of this period. At the same time the treaties determine a condition for application of the tax spared credit according to which the competent Yugoslav authority must confirm that the purpose of the tax facility accounts for encouragement of the development in Yugoslavia.

IV. CONCLUSION

In view of the above and particularly in light of the experience and the interest of Yugoslavia in stimulating foreign investments sofar, it may be realistically expected that further mesures will be undertaken to create even more favourable conditions for foreign investments. This will be done through appropriate amendments in the Law on Investment of Resources of Foreign Persons in Domestic Organizations of Associated Labour and in the provisions on taxing foreign persons as well as through conclusion of the treaties on the avoidance of double taxation with the countries whose residents are interested in investing in Yugoslavia.

Photo impressions of the First East-West Tax Conference in Salzburg on 14 and 15 April 1987

Ludmilla Mamet from the U.S.S.R. Ministry of Finance, Tax Department, Moscow addresses the audience. Seated are Prof. Dr. Dennis Campbell of McGeorge School of Law, Salzburg, Austria (left) and Prof. Dr. Jan Głuchowski of Copernicus University, Torún, Poland.



Prof. Dr. Dennis Campbell of McGeorge School of Law, Salzburg, Austria, Chairman, opens the morning session. Seated are Andrew Miles of Price Waterhouse, Frankfurt, West Germany and Dr. Herwig E. Haase of the Free University of Berlin, Berlin, West Germany.

A view of the Conference Hall with the participants.

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East-West Tax Treaties

By Willem G. Kuiper

Willem G. Kuiper (1949) graduated in tax law from the State University of Leyden, the Netherlands in 1974, after which he took up employment with the International Bureau of Fiscal Documentation in Amsterdam. He acted as a coordinating editor of a loose-leaf service on *"Taxation in European Socialist Countries"*, published in 1981. He presently is the Editor-in-Chief of *European Taxation*, one of the IBFD's monthly tax periodicals, as well as coordinator of scientific production. Mr. Kuiper is the author of one book on taxation in Eastern Europe, several chapters on loose-leaf publications and many articles on international taxation published both in the Netherlands and abroad.

I. INTRODUCTION

The preceding articles in this issue on East-West tax matters have shown that the conducting of business operations in Eastern Europe by non-resident entrepreneurs, other than direct trading without any local business establishment, generally leads to liability for income or profits taxes in those countries. This, of course, may result in international double taxation of such profits. The same holds true for the income tax liability of foreign personnel temporarily sent to perform specific activities in Eastern Europe. The existence of international double taxation, or at least the possibility thereof, has given rise to the conclusion of tax treaties between socialist and non-socialist countries, a development which started in 1972 with the conclusion of a comprehensive double taxation treaty between the Federal Republic of Germany and Poland.[1] Note, however, that in 1972 a number of tax treaties between Eastern European countries and Western countries, which were concluded before World War II, were still in force (e.g. the treaties concluded by Hungary with Italy, Sweden and the Netherlands). There are, at present, nearly 100 of such tax treaties between the East and the West in force, and several others are being negotiated.

II. COMPARISON WITH THE OECD MODEL

In an earlier article, published in 1975[2], it had already been pointed out that most of the 15 treaties which were in force at that time (with the exception of the treaties concluded by Hungary before World War II and the treaty concluded between the U.S.S.R. and the United States) generally followed the pattern of the 1963 OECD Draft Double Taxation Convention. However, in most of these treaties, there were a few provisions which were significantly different from the OECD Draft. In particular, these major differences can be divided into the following categories:

(1) treatment of building sites and construction projects as permanent establishments;
(2) withholding taxes on dividends, interest and royalties;
(3) the tax treatment of capital gains; and
(4) the tax treatment of employment income.

As far as building sites and construction projects were concerned Art. 5(2)(g) of the 1963 OECD Draft provided (as does the 1977 OECD Model) that these were considered permanent establishments if they existed for a period of more than 12 months. Of the treaties in force in 1975, only one treaty (i.e. the one between Romania and the United States) contained a provision which is identical to the OECD Draft.

The other post-war treaties generally provide that building sites and construction projects are considered permanent establishments after 18, 24 or 36 months, while in two treaties such building sites and construction projects are never considered permanent establishments.

According to Art. 10 of the 1963 OECD Draft, dividends may be taxed in both States, but the tax rate in the State of source should not exceed 5% (in the case of substantial holdings) or 15% in other cases. In the East-West treaties in force in 1975, such a "split-rate" system was only followed in 4 treaties; most post-war treaties between East and West, however, contained a single maximum withholding tax rate of 10%. The treaty between the United States and the U.S.S.R. does not contain a provision on dividends.

1. Treaty of 18 December 1972, published in the German Official Gazette, Part II, 1975, at 645.
2. See W.G. Kuiper, "East-West tax treaties", 15 *European Taxation* (June 1975) at 185-199.

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However, given the limited significance of capital investment by Western companies in Eastern European enterprises in the early seventies, the importance of the dividend-article in tax treaties was only that of a one-way street, i.e. dividends paid from the West to Eastern Europe. This, of course, has changed considerably in more recent years, taking into account the increased interest of Western companies for investment in Eastern Europe in the form of joint ventures.

Art. 11 of the 1963 OECD Draft states that interest can be taxed in the State in which it arises, but the rate of the tax may not exceed 10%. Only the three treaties in force in 1975 concluded by Romania provided for such a 10% withholding tax, while under the other post-war treaties no such withholding tax may be levied. Given the high indebtedness of Eastern European countries, this reduction is, of course, not without importance.

However, it should also be noted that some Eastern European countries do not impose a withholding tax at all (e.g. Hungary and the U.S.S.R.).

Art. 12 of the 1963 OECD Draft permits the taxation of royalties in the State of the recipient with no provision for a withholding tax in the State in which the royalties arose. In this respect, only 4 post-war East-West treaties follow the OECD Draft, but the others provide for a 5% or 10% withholding tax in the State of source. In the light of the predominant flow of technology from the West to the East, this must be considered a significant reduction of the tax burden in Eastern Europe.

Notwithstanding any other differences between the 1963 OECD Draft and the East-West tax treaties, one other detail concerning the taxation of employment income in some treaties should be noted. In some East-West tax treaties the 183-day term in Art. 15(2)(b) of the OECD Draft has been substituted by 12 months (Austria–Poland) or even 18 months (France–Romania)[3], while the treaties concluded by the Federal Republic of Germany with Poland and Romania provide that, in the case of personnel employed at a building site or construction project in the other Contracting State, the 183-day term is substituted by the term after which such building sites or construction projects are considered permanent establishments according to these treaties, i.e. 12 months.[4]

It should be noted, however, that, when foreign employees temporarily working in Eastern European countries are subject to income tax in these countries by virtue of treaty provisions, the income tax rates are usually extremely low (with the exception of Hungary).[5] The advantage thereof, however, may wholly or partially disappear as a result of provisions in domestic law or tax treaties concerning the avoidance of double taxation (i.e. where world-wide income is taxed and a credit for foreign tax is given or when foreign-source income is exempt, but the tax rates are determined by world-wide income (exemption-with progression)).

In East-West tax treaties concluded after 1975, and more in particular in the treaties based on the pattern of the 1977 OECD Model Convention, it can be observed that there is a trend towards an even closer resemblance with the OECD Model. This is particularly true for the provisions concerning building sites and construction projects (where the 12-month term is more frequently followed) and the withholding tax on royalties which, in contrast with the earliest East-West tax treaties, is no longer levied in the State of source in the majority of cases (the treaties concluded by Romania being the most important exception).

Withholding taxes on interest are, as was the case under the earliest East-West tax treaties, not levied in the State of source, again with the Romanian treaties as the most important exception. Hungary has replaced its pre-World War II treaties with the Netherlands, Sweden and Switzerland[6] by new treaties which closely follow the OECD pattern. Moreover, where treaties concluded by the Soviet-Union were originally based mainly on the principle of reciprocal exemptions (e.g. the treaties with the United States and Finland[7]), there is now a trend towards greater resemblance to the OECD Model in the tax treaties concluded by the U.S.S.R., particularly in the tax treaties concluded after 1980 (although the terminology and the order of the articles still significantly differ from the OECD Model). One important exception in this respect is that the treaties concluded by the U.S.S.R. (as well as the few treaties concluded by Bulgaria, and a limited number of other East-West treaties, e.g. the treaty between Germany and Romania) do not contain a provision concerning associated enterprises. In light of the increasing interest for capital investment in the form of joint ventures, this may become more important for matters of transfer pricing because it is possible that such joint ventures will be considered related enterprises (when taking into consideration that, for example, under some domestic legislation, as well as under the 1979 OECD Reports on Transfer Pricing and Multinational Enterprises, an interest of less than 50% could be sufficient to designate the companies concerned as related enterprises).

Finally, it should be noted that the tax treaties concluded by Yugoslavia contain a provision with respect to the tax treatment of profit distributions by joint ventures established in Yugoslavia which substantially differs from the OECD Model (see Sec. III.C below).

3. Art. 15(2)(c) of the tax treaty between Austria and Poland of 2 October 1974; Art. 15(2)(a) of the tax treaty between France and Romania of 27 September 1974.
4. Point 4 of the Final Protocol to the tax treaty Germany–Poland; point 5 of the Final Protocol to the tax treaty Germany–Romania.
5. See W.G. Kuiper, "The structure and developments of socialist tax law from a Western point of view", in 39 *Bulletin for International Fiscal Documentation* 484 et seq. (November 1985).
6. The new tax treaties were concluded on 9 April 1981 (Switzerland), 12 October 1981 (Sweden) and 5 June 1986 (the Netherlands).
7. For a discussion of these tax treaties, see *Guides to European Taxation, Vol. V, Taxation in European Socialist Countries,* Chapter U.S.S.R., Sec. 13.3. The English text of the treaty between the U.S.A. and the U.S.S.R. was printed in *Supplementary Service to European Taxation*, Sec. C.

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III. THE ROLE OF EAST-WEST TAX TREATIES

A. In general

The role of East-West tax treaties can only be analyzed when taking into account a number of other aspects, including the following[8]:

(1) the overall difference between the socio-economic systems (including the tax systems) of Western and Eastern European countries; and
(2) Eastern European legislation with regard to trade with Western countries and investment by Western companies on the territory of socialist countries against the background of the economic and financial situation in Eastern European countries.

The structural starting points for an understanding of socialist tax systems are the possible taxpayer categories and the taxes to which they are subject. As far as categories of taxpayers are concerned, the following may be distinguished at present:

- State and cooperative enterprises;
- domestic enterprises in the private sector;
- individual citizens; and
- foreigners.

The latter category usually includes: joint ventures, domestic representative offices of foreign companies, foreign companies doing business in socialist countries in other forms or obtaining Eastern European-source income, as well as foreign individuals temporarily resident in these countries or obtaining Eastern European-source income otherwise. The reason for having such a special category of taxpayers is not found in any rule of tax law, but in Eastern European foreign exchange legislation (which usually draws a distinction between "exchange nationals" and "exchange foreigners"[9]). It should be noted, however, that each of the above categories of taxpayers are subject to different tax regimes with different taxes, taxable bases and tax rates. Moreover, as far as East-West joint ventures are concerned, this classification as foreign taxpayers leads, upon distribution, to the result that, unless the profits are reinvested, a part of the profits is remitted abroad to the foreign partner, while another part is remitted to the domestic partner who usually falls within another group of taxpayers, i.e. the group of State and cooperative taxpayers.

B. Different tax treatment of intra-CMEA and East-West joint ventures

Having thus found that Eastern European and Western tax systems differ substantially, both as far as individual taxpayers and legal entities are concerned, it is perhaps surprising that most East-West tax treaties follow the OECD Model so closely and that they do not contain provisions concerning the personal scope which takes account of this special situation. For example, as far as East-West joint ventures are concerned, the absence of such a special provision could, at least in theory, lead to the following disparity in treatment:

- a corporate East-West joint venture established in the West is treated as a resident taxpayer and subject to corporate income tax in the West on its world-wide income; it is entitled to all allowances, deductions and exemptions, as well as to double taxation relief (including for income derived from a foreign permanent establishment), in the same way as other corporate taxpayers resident in that country.
- a corporate East-West joint venture established in an Eastern European country (and, therefore, for tax purposes, resident in that country) is considered as a foreign taxpayer, but nonetheless, and although it is subject to corporate income tax on its world-wide income, it is entitled to other allowances, deductions and exemptions than those to which resident taxpayers are entitled to in that Eastern European country, and without an explicit tax treaty provision that the joint venture is, at least for treaty purposes, considered as a resident taxpayer (and the majority of East-West tax treaties do not contain such a special provision), it is doubtful whether such a joint venture is entitled to double taxation relief (including relief for income derived from a foreign permanent establishment) in the country in which it is established.

The above disparity may be mitigated by the sometimes rather far-reaching tax incentives granted to joint ventures in Eastern European countries.

However, the disparities in treatment are magnified when the tax treatment of the Western investor (particularly the Western partner in an East-West joint venture) is compared with that of an investor from a CMEA country who is entitled to double taxation relief under one of the two multilateral double taxation treaties between CMEA countries. In this respect, it should be noted that, prior to the conclusion of these treaties, the establishment of intra-CMEA joint ventures was already possible, particularly on the basis of a CMEA Model Statute adopted in 1976 or on the basis of bilateral agreements.[10] The tax treatment of such joint ventures is already laid down in the articles of association, i.e. they are subject to tax on their profits in the State in which they have their seat. The multilateral CMEA treaty for the avoidance of double taxation of legal entities confirms this practice; however, it also adds an element to the tax treatment of such joint ventures (i.e. an element which was not applied in previous practice) in so far as the distribution of profits is concerned. This situation results in the following differences (as far as taxation is concerned) between intra-CMEA joint ventures and East-West joint ventures:

(1) the tax treatment of intra-CMEA joint ventures is, at least in first instance, based on contract law, i.e. the agreement of association, and not on any pro-

8. See Kuiper, note 5, supra, at 483.
9. For a more detailed discussion of these terms, see e.g. *Guides to European Taxation, Vol. V, Taxation in European Socialist Countries*, Chapter Czechoslovakia, Sec. 11.1.
10. See *Guides to European Taxation, Vol. V, Taxation in European Socialist Countries*, Chapter CMEA, Sec. 3.5.

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vision of domestic tax law or any principle of international public law;

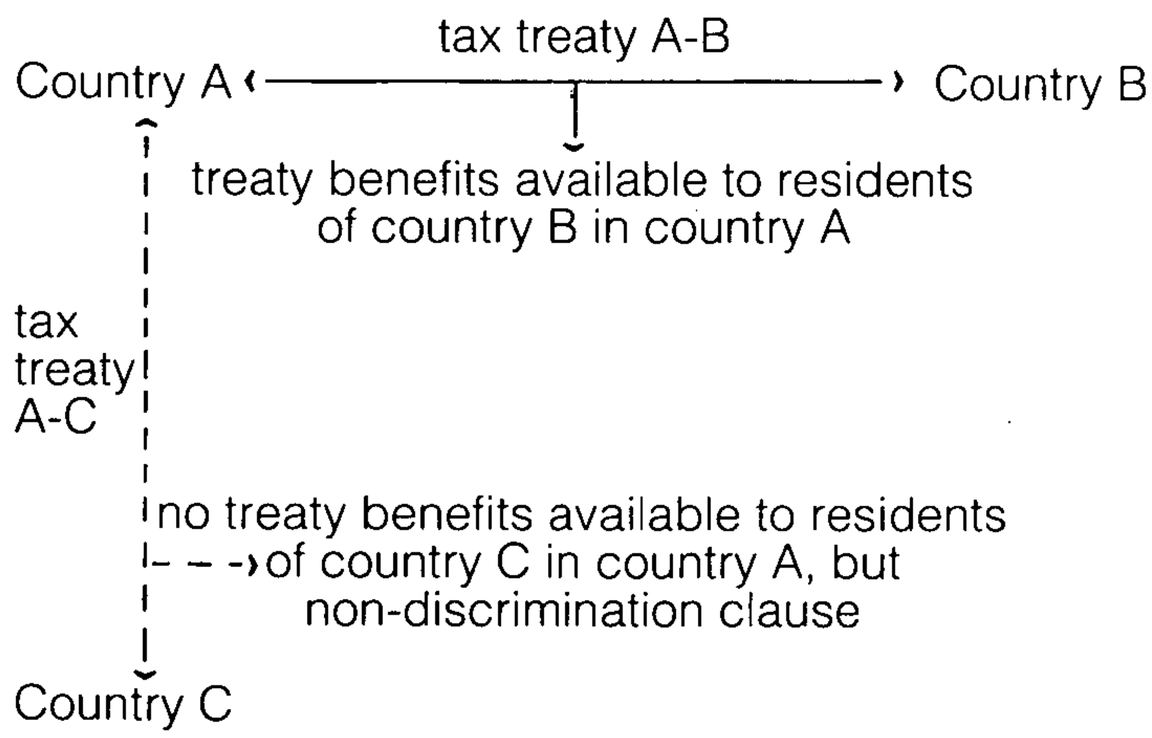
(2) intra-CMEA joint ventures are taxed as domestic enterprises in the country in which they are established, while East-West joint ventures are treated as foreign taxpayers;

(3) the distribution of profits is treated, for tax purposes, in a different manner, both as far as the withholding tax on profit distributions in the source country (i.e. no withholding tax under the CMEA treaty) and the tax treatment in the home country of the foreign investor (i.e. no tax liability in the home country under the CMEA treaty), depending on whether it is based on either the multilateral CMEA tax treaty or on bilateral East-West tax treaties.

Taking into account the above differences, the question arises as to whether this situation leads to a conflict with the non-discrimination provision under East-West tax treaties. The importance of this question particularly arises not only with respect to the right to impose a withholding tax on dividends and any other form of profit distribution but also with respect to the question whether the home country of the foreign investor is or is not entitled to subject such profit distributions to tax *by virtue of the treaty*. The impact of these questions may be illustrated by the following example:

Assume that nationals of State A are granted favourable treatment not by the domestic law of State A, but by a treaty concluded between State A and State B which also accords these privileges to nationals of State B. If State A has also concluded a treaty with State C which contains a non-discrimination clause, the question arises whether C-nationals should be entitled to the benefits available to A and B-nationals under the treaty between A and B.

This may be illustrated by the chart below.



Based on the Commentary to the OECD Model[11], the question could perhaps be answered in the affirmative as far as the tax burden on A and C-nationals is concerned.

However, as far as the relationship between B and C-nationals is concerned, the answer is more difficult to give. Nevertheless, one could imagine that this question is also answered in the affirmative, when B-nationals in State A are treated as resident taxpayers, such as is the case under the multilateral CMEA tax treaty.

In the light of the growing importance of East-West joint ventures, the interest in this question may gain increased importance[12] in the near future. Much will depend on a flexible interpretation of tax treaties, particularly by Eastern European countries. This might help to solve the problems indicated, at least in part. This is particularly true when bearing in mind that, with only few exceptions (e.g. the treaties concluded by West Germany with Poland and Romania), most East-West tax treaties contain a non-discrimination clause which, in essence, resembles the provision in the OECD Model.[13] If so, the importance of the application of East-West tax treaties in practice will also increase.

C. Desirability of changes in East-West tax treaties

It would carry too far to argue, as has been done[14], that, based on the existing socio-economic differences between socialist and non-socialist countries, tax treaties based on the OECD Model would be less appropriate for East-West tax treaties. Slight modifications to the OECD Model, e.g. by incorporating proper definitions of the terms "resident", "person", "company" and/or "legal entity" may also offer a solution, provided that such definitions sufficiently cover all classes of taxpayers covered by the treaties and provided that such different or additional definitions are consequently taken into account in other treaties.

But there is more. In spite of the intensification of East-West trade, particularly in recent years in the form of joint ventures, other forms of East-West business operations should not be overlooked, particularly from the point of view of the overall socio-economic situation and the legislation approving specific forms of doing business in Eastern European countries. In this respect, special attention should be given to loan transactions and the transfer of technology without a

11. See points 9 and 10 of the Commentary to Art. 24 of the OECD Model Convention.

12. This question will be less important in the case of Hungary and Poland (for joint venture under the 1986 law only), given the absence of any withholding taxes on profit distributions paid abroad.

13. Note, however, that the provisions concerning stateless persons and the "deductibility clause" as contained in Art. 24(5) of the OECD Model Convention do not appear in most East-West tax treaties. The latter provision reads as follows:

> Except where the provisions of paragraph 1 of Article 9, paragraph 6 of Article 11, or paragraph 4 of Article 12, apply, interest, royalties and other disbursements paid by an enterprise of a 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 the Contracting State shall, for the purpose of determining the taxable capital of such enterprise, be deductible under the same conditions as if they had been contracted to a resident of the first-mentioned State.

14. See H. Debatin, "The role of tax treaties as an instrument of economic cooperation between "capitalist" and "socialist" countries", in 39 *Bulletin for International Fiscal Documentation* 393 (August/September 1985).

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specific form of direct foreign investment (e.g. in the form of a subsidiary or a permanent establishment), particularly when bearing in mind the increasing need of socialist countries for convertible currencies and modern technology. Under many tax treaties in force, socialist countries have already shown their willingness to considerably reduce or to waive their normally high withholding tax rates on royalties and, to a lesser extent, on interest paid abroad. If Western borrowers and licensors are assured that the granting of licences or loan capital to entities in socialist countries will not be hampered by taxation at source (which regularly is imposed on the gross income paid), this will facilitate the realization of such East-West business transactions. I agree with Debatin[15] that the concern from the point of view of a State that, due to the waiver of taxation at source, too much would be paid in terms of royalties and interest is, for socialist countries, hardly relevant as they subject nearly all licence and loan contracts with foreigners to Government approval. A few more words about dividends and other forms of profit distributions. In fact, this concept, attuned to the free market system, is essentially alien to planned economies. Nevertheless, socialist countries have acquiesced in the idea that, as mentioned above, their State enterprises may obtain capital investment from Western investors to whom an adequate share in the profits is to be allocated. The classification of such income for tax purposes is, however, in many respects not fully clarified, because the participation of Western companies in qualifying ventures in socialist countries often take the form of a "package deal". Regularly, the actual capital participation is coupled with the provision of loan capital (to the extent that this is allowed under socialist legislation) and particularly the furnishing of technical assistance. However, from a tax point of view, the question arises as to how, in such a situation, the income is to be dissected into its various components. Take as an example an investment contract under which capital as well as equipment is furnished and, in addition, patents are licensed and technical assistance is supplied. Which slice of income is to be allocated to each of these elements? It is true that this is certainly not a problem which is unique to East-West relations; rather, it is the overriding goal of a well functioning system of international cooperation in more general terms. Up to now, however, the momentum of the upswing in economic cooperation between East and West has prevented this problem from coming out into the open, but sooner or later it will require clarification. For the time being, however, it appears that this point should be brought to the table when negotiating such investment contracts.

D. Tax treatment in Western countries

Finally, under the aspect of international entrepreneurial cooperation, it is also of crucial importance what tax reliefs Western countries grant their companies for investment and other forms of doing business in socialist States. In this respect, it is noteworthy that, unlike under tax treaties between developed and developing countries there are, to my knowledge, no East-West tax treaties under which Western countries are prepared to grant tax sparing credits in respect of Eastern European taxes on investment income, except for the treaties concluded by Yugoslavia with Denmark, Italy, Norway, Sweden and the United Kingdom[16].

Under those treaties, there is some sort of tax sparing credit for exemptions of reductions of Yugoslav income tax in respect of the foreign partner's share in the profits of a Yugoslav joint venture. However, under the treaty with Norway, this is limited to a maximum period of 10 years and under the treaty with Italy to a maximum percentage of 25.[17] Thus, Western countries, in their position as State of residence, generally fully tax inflowing dividends, interest and royalties. An important exception to this approach is the granting, either unilaterally (such as in the Netherlands and Austria) or on the basis of a treaty provision of the affiliation privilege, according to which dividends from substantial holdings in other companies are fully or largely exempt from corporate income tax in the home country of the foreign investor. To the extent that such an international affiliation privilege is not granted unilaterally (e.g. in the United Kingdom), treaty provisions could offer such relief. This is the case, for example under the U.K.–Hungarian tax treaty[18], but a credit for underlying taxes is not granted under treaty provisions in some other cases (e.g. the U.K.–Romanian tax treaty).

Lastly, let me say a few words about Yugoslavia, and particularly about a special provision contained in the tax treaties concluded by this country concerning profit distributions by joint ventures. With the exception of the treaties concluded by Yugoslavia with France and the United Kingdom, all other Yugoslav tax treaties provide that the foreign partner's share in the net income of a Yugoslav joint venture shall be taxed in accordance with Article 7 of the various treaties (concerning the taxation of business profits), thus granting the taxing rights to Yugoslavia. From the point of view of Yugoslavia, this is not surprising, because joint ventures in Yugoslavia are of a non-corporate type.

Nevertheless, the existence of such a specific provision looks a bit strange in treaties with countries which adhere to the exemption method as a manner of double taxation relief for the taxation of business profits which, by virtue of the treaty, may be taxed in the country where there is a permanent establishment. And particularly, the only Yugoslav treaty with a country which does not apply the exemption method under its tax treaties (i.e. the United Kingdom) contains such an explicit provision to the contrary (while the treaty with France does not contain an explicit provision at all).

15. See note 14, supra at 398.
16. See the various articles in the relevant tax treaties concerning the elimination of double taxation.
17. See Art. 23(4) of the tax treaty between Italy and Yugoslavia and Art. 23(2)(c) of the treaty between Norway and Yugoslavia.
18. Art. 23 (1)(b) of the tax treaty United Kingdom–Hungary.

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IV. SOME "TAX PLANNING" TECHNIQUES

When summarizing the above, one can say that there is not only a large variety of domestic tax law provisions which the foreign investor in socialist countries has to take into account in order to reduce the tax burden on his Eastern European-source investment income, but also an increasing number of tax treaties all of which, though in principle based on the OECD Model, have their own peculiarities. Moreover, in spite of the increasing number of tax treaties between East and West, there are still a number of important gaps in the "East-West treaty network". This holds true not in the last place with respect to the German Democratic Republic and Bulgaria. Both these countries have concluded tax treaties with very few countries, and certainly not with the major Western countries. But there are other gaps as well. For example, up to now, Czechoslovakia has not concluded tax treaties with the United States, the United Kingdom or Switzerland. In addition, there are no tax treaties between Yugoslavia and Japan, West Germany and Austria, as well as between the U.S.S.R. and Denmark. Moreover, the reduction of Eastern European withholding taxes on dividends, interest and royalties is not considerable in some cases (particularly under most tax treaties concluded by Romania). This, of course, makes it necessary "to find one's way" in the East-West treaty network, in order to reduce the Eastern European tax burden on business and investment income as much as possible. This is particularly true for royalties from Eastern European sources which are normally subject to Eastern European taxes at high rates (although this does not apply, or only to a lesser extent, under the tax treaties concluded by Hungary and the U.S.S.R.).

The tax treaties concluded by Austria with Bulgaria, Poland and the U.S.S.R., as well as the treaties between Germany and Poland and those concluded by Sweden and France with Yugoslavia provide for a 0% withholding tax on royalties. Depending on the tax treatment in the Western country, these treaties may be a useful instrument to channel royalties from East to West.

A similar trend can be observed with respect to dividends and other profit distribution (particularly profit repatriations of joint ventures). In this respect, the treaties concluded by the U.S.S.R. with Austria and the United Kingdom appear to be useful instruments to minimize the withholding tax on dividends. The same applies to the Austrian–Bulgarian and the Netherlands–Czechoslovakian tax treaties. However, when bearing in mind that both Austria and the Netherlands apply, under certain conditions, the affiliation privilege for dividends from abroad, it appears that the Netherlands and Austria are in a much better position to channel Eastern European-source dividends. I trust that the term "Dutch sandwich" construction (i.e. the relationship between a Netherlands Antilles company which owns a Dutch company, the latter owning on its turn one or more companies in other countries) is well-known to you in this respect. For the same and other reasons, the Netherlands may be an advantageous location to channel Eastern European-source interest through intermediary financing companies based in the Netherlands.

With respect to the channelling of Eastern European-source income, it appears, however, that Cyprus may also play a special role. Before going into more detail on this matter, some other provisions in East-West tax treaties which may be advantageous to Western businessmen operating in Eastern Europe should be mentioned, including the following:

- for building sites and construction projects the treaties concluded by Czechoslovakia with France and the Netherlands provide that these will never be regarded as a permanent establishment in the other country.[19] Given the fact that profits from such building sites and construction projects are taxed at a rate of 50%[20], companies based in France and the Netherlands are somewhat better of in this respect;
- for Western companies which are frequently trading with (but not investing in) Eastern Europe, it is not unusual to have an agency in Eastern Europe, and this is explicitly allowed under the legislation of all Eastern European countries. These agencies normally fall under the treaty provision concerning dependent agents and are, therefore, considered permanent establishments in the Eastern European country concerned. An important exception to this rule is contained in the Austrian–Bulgarian tax treaty which does not contain such a provision. To conclude, a few words about the role which Cyprus plays, or at least may play, in East-West business operations.[21] According to the treaties concluded by Cyprus with 7 Eastern European countries (the only exception being Poland), the rates of the withholding taxes have been reduced considerably.

Although there are more important East-West tax treaties under which withholding taxes have been reduced to the same low level, Cyprus may still play an important role when taking into account the following:

- there are still important gaps in the East-West treaty network;
- Cyprus has concluded tax treaties with the G.D.R. and Bulgaria, both of which have concluded only a very limited number of tax treaties;
- tax treaties concluded by Cyprus with Eastern European countries do, in some cases, not contain a provision that the recipient of Eastern European-source income must also be the beneficial owner of such income; and
- the domestic tax legislation with regard to offshore companies which may serve as a conduit to channel Eastern European-source investment income.

19. Art. 5(3)(f) of the tax treaties concluded by Czechoslovakia with France and the Netherlands.
20. See *Guides to European Taxation, Vol. V, Taxation in European Socialist Countries,* Chapter Czechoslovakia, Secs. 12.2 and 12.4.
21. For more details, see W.G. Kuiper, "Cyprus: Turntable between East and West", in 24 *European Taxation* 175 et seq. (June 1984).

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As regards the latter, it should be noted that, for purposes of corporate income tax in Cyprus, a distinction should be made, as usual, between resident and non-resident companies, and a further distinction between companies that derive income from sources within Cyprus and those that derive income exclusively from sources outside Cyprus. Companies in the latter category are known as off-shore companies. Similarly, it is also possible to set up an offshore branch in Cyprus.

Where "normal" resident and non-resident companies in Cyprus are subject to corporate income tax at a rate of 42.5%, such offshore companies only pay one-tenth of this rate, i.e. 4.25%. Shareholders receiving a dividend from an offshore company out of their profits are not subject to any tax in addition to the tax paid or payable by the company.

According to Cypriot tax law, income from investment is deemed to emanate from sources outside Cyprus, if the capital is used for activities outside Cyprus, and, for this purpose, the place of investment and the parties to the particular agreement are immaterial. This provision enables one Cypriot offshore company to be a shareholder or to finance another Cypriot offshore company. If the former, i.e. the holding company, receives dividends from the latter which have been taxed at a rate of 4.25%, there will be no further tax liability in Cyprus when the holding company distributed its own profits to its shareholders. In this way, Cypriot offshore companies may be a useful instrument to minimize the tax burden on Eastern European-source investment income. As far as dividends are concerned, the withholding taxes levied in Eastern European countries are creditable against corporate income tax due in Cyprus. Since the rate of this tax is 4.25%, the total effective tax burden on such dividends is the tax levied at the source in the Eastern European country. Or, where such withholding tax is nil (e.g. under the treaty between the U.S.S.R. and Cyprus wherein there is no provision on beneficial ownership), the tax burden is minimized to 4.25% only. Thus, an intermediate offshore company in Cyprus may also benefit from the lower treaty rates, even in the case of redistribution to its shareholders abroad.

Similar advantages may be obtained with respect to interest and royalties, although, in the case of interest, the advantages are less important, because most Eastern European countries do not levy a withholding tax thereon according to domestic tax legislation.

However, in the case of royalties, which are usually subject to high withholding taxes in Eastern Europe, the use of a conduit in Cyprus may be extremely useful, and it has proven to be so in practice.

However, before using the "Cyprus-route", a warning should be made. First of all, the Western company should be sure that the use of this device is acceptable to Eastern European authorities, as in some cases, domestic regulations in Eastern European countries (e.g. exchange controls such as those in the relationship between East and West Germany) prevent this. Moreover, one should be aware of the fact that any anti-avoidance legislation in Western countries may also be applied in such cases. This is also true for purposes of the tax treaties between Cyprus and the United Kingdom and West Germany. For example, the U.K.–Cyprus tax treaty excludes certain legal entities in Cyprus from the benefits of the treaty relating to dividends, interest and royalties. However, as far as dividends are concerned, the new provision only affects dividends paid by a company resident in the U.K. to a resident in Cyprus. Moreover, the treaty does not affect foreign-source interest and royalties received by an offshore company in Cyprus from a country other than the U.K., as long as the income is accumulated in Cyprus.

However, it is beyond the scope of this article to discuss all relevant anti-avoidance legislation in Western countries (particularly the provisions concerning controlled foreign corporations). Nevertheless, it appears that, in spite of various risks, Cyprus may be, and in fact has proven to be, an advantageous location to channel Eastern European investment income.

V. CONCLUSION

This article only covers a few aspects of East-West tax treaties. This was inevitable, given the broadness of the subject. Nevertheless, I have tried to give an impression of the most important issues in practice. Professional advice, however, will always remain necessary, whatever form is chosen for doing business with Eastern Europe. Furthermore, given the increased interest in investment in Eastern Europe and the new legislation concerning such investment, the role of East-West tax treaties will gain importance in the near future. It can only be hoped that the application of these treaties by the Eastern European authorities will be clarified in the near future. Such a clarification should also focus on the issues raised in this paper, such as the possible application of the non-discrimination provision under East-West tax treaties, insofar as the tax treatment of East-West joint ventures (as compared with that of intra-CMEA joint ventures) is concerned. The introduction of special, harmonized legislation on the tax treatment of such intra-CMEA joint ventures (instead of the incorporation of a tax provision in the agreement by which such intra-CMEA are established) appears to be a prerequisite therefor. Alternatively, slight modifications in East-West tax treaties could also contribute to a solution in this respect.

On the other hand, it has been pointed out that, as long as the issues raised have not been clarified, it is important for Western businessmen to know the most tax-favourable way for doing business with Eastern Europe. In this respect, it should be noted that, in spite of the increasing density of the East-West tax treaty network, there are still important gaps, but perhaps the tax treaties concluded by Cyprus with most Eastern European countries may create a new perspective, particularly when taking into account the tax-friendly climate for foreign investors in Cyprus itself.

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CANADA:

Proposals for Tax Reform

By Allan R. Lanthier

Every reform, however necessary, will by weak minds be carried to an excess, that itself will need reforming.[1]

I. INTRODUCTION

On 18 June 1987, sixteen years to the day that major tax reform legislation was last tabled in the House of Commons, federal Finance Minister Michael Wilson released the Conservative Government's proposals for tax reform in the form of a White Paper. As part of the tax reform package, Mr. Wilson also tabled a separate Notice of Ways and Means Motion dealing with income tax proposals that are generally effective immediately. Many of the tax reform proposals had been referred to in earlier discussion papers issued by the Department of Finance and in statements from Government officials, and the only major surprise was the somewhat limited scope of the Government's final product.

Tax reform will proceed in two stages. The first stage involves personal and corporate income tax measures, most of which will become effective in 1988. The House of Commons Standing Committee on Finance and Economic Affairs has begun hearings on these proposals, and draft legislation is expected by the end of the year. The second stage will be the implementation of a new multi-stage sales tax to replace the current federal sales tax. The reform of the sales tax system has been put forward in the form of three options, with no scheduled effective date, and it is expected that the earliest possible implementation date would be 1990. The existing 3% surtax applicable to both personal and corporate income tax will continue to apply until sales tax reform is implemented.

Overall, the tax reform proposals are expected to be essentially revenue neutral over the next four fiscal years, with corporate and consumption tax revenues increasing as a share of total revenues and personal income tax declining.[2] While corporations will bear a heavier tax burden after reform, this increased burden will not be shared equally between different industry sectors. In general, tax reform will penalize capital-intensive industries as a result of changes to the capital cost allowance and investment tax credit systems, while providing benefits to the more labour-intensive service sector which has been the major creator of new jobs in Canada over the last five years. Hardest hit in the corporate area are financial institutions and insurance and real estate companies, who will see their average effective tax rate on financial statement income rise from 14.5% to 21.3% based on Government estimates, an increase of almost 47%.

After incorporating the impact of tax reform, Mr. Wilson forecasts that the annual Canadian federal deficit will decline over the next five years, from $29.3 billion in the current year to $23.5 billion by 1991/1992. While these projected reductions are encouraging, they do not achieve the Minister's previously indicated targets for improvement in this area, and in addition are based on economic forecasts which may prove to be somewhat optimistic.

As indicated above, the proposals which Mr. Wilson has put forward are less dramatic than had been expected and are clearly less significant than those introduced in the last Canadian reform sixteen years ago. There has been some base-broadening and reduction of personal and corporate income tax rates; however, the existing income tax system has fundamentally been left in place.

1. Samuel Taylor Coleridge, Biographia Literaria, Chapter 1.

2. Personal income taxes are projected to decline by $10.3 billion over the next four fiscal years, while corporate income tax and consumption taxes are forecast to increase by $3.8 billion and $4.8 billion respectively. Other revenue measures having a one-time impact (acceleration of source deductions and tax payments) will generate a further $2.7 billion of revenue.

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The highlights of the Canadian tax reform proposals:

- The base for personal and corporate income tax would be broadened by eliminating or reducing various tax preferences and incentives, and income tax rates would be reduced. This combination of a broader base and lower rates is the cornerstone of the tax reform proposals.
- There are numerous base-broadening proposals. These include an increase in the proportion of capital gains which must be included in a taxpayer's income from 50% at present to 75% by 1990, a reduction of capital cost allowance rates applicable to various classes of depreciable assets, and various specific measures affecting certain industry sectors, notably financial institutions and insurance and real estate companies.
- The top federal income tax rate applicable to individuals would drop from 34% at present to 29% in 1988. Assuming no change in present provincial tax rates, and including the 3% federal surtax, the maximum federal-provincial personal tax rate would be approximately 46% in 1988, down from approximately 54% at present.[1]
- The general federal corporate tax rate would be reduced from 36% to 28%, generally effective 1 July 1988. Again using existing provincial tax rates and including the 3% federal surtax, the combined federal-provincial corporate tax rate would be approximately 43% after tax reform, compared with approximately 50% at present.[2] Lower rates would continue to apply to income from manufacturing and to small business income.
- The general investment tax credit applicable to acquisitions of qualifying depreciable assets would continue to be phased out by 1989, while the investment tax credit for research and development expenditures would remain unchanged. For taxation years ending after 1987, investment tax credits would generally be available to offset only 50% of federal tax payable.
- An advance corporation tax of 25% (or 40% in certain circumstances) would be introduced in respect of dividends on most preferred shares issued after 18 June 1987.
- A broad new anti-avoidance measure would be introduced which would contain "bona fide business purpose" and "step transaction" tests. Certain existing anti-avoidance rules which are considered to be ineffective would be repealed or revised.
- A number of changes would be introduced affecting administration and compliance, certain of which would be directed against international transactions.
- Three alternative proposals for a multi-stage sales tax have been put forward for review and discussion. In the interim, a number of specific measures have been proposed, generally effective as of 1 January 1988, to raise additional revenue from the existing federal sales tax system.
- There would be no change at this time to the existing and generally favourable foreign affiliate rules related to international income.[3]

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1. The actual combined federal-provincial personal tax rate generally depends on an individual's province of residence. A table showing the top marginal rates for 1987 and 1988 on a province-by-province basis is included below under Sec. IV.A. (Personal tax changes).
2. The actual combined federal-provincial corporate tax rate is determined with reference to the province in which the business is carried on, using a two-factor formula (wages and revenue). The combined rate after tax reform will range from approximately 35% to 46%, depending on the province in question.
3. However, officials from the Department of Finance have indicated that changes in the international area continue to be under consideration and could be proposed at some future time.

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While the White Paper does not represent an overly ambitious effort, the lack of any major upheaval in the Canadian tax system should in and of itself be of some comfort to Canadian taxpayers and to foreign investors.

After commenting briefly on the history of tax reform in Canada and on the objectives of the current reform, the balance of this article reviews and comments on the more important aspects of Mr. Wilson's tax reform proposals. The reader should note that enabling legislation is not yet available for review, and that there could be changes to certain of the proposals as a result of public comment and debate.

II. HISTORY OF CANADIAN TAX REFORM

Tax reform is not a new experience for Canadians. The last major tax reform proposals had been tabled on 18 June 1971, following a 10-year study and debate on the Canadian tax system.

The 1971 reform had commenced with the appointment of a Royal Commission on Taxation in 1962 under the chairmanship of the Late Kenneth Carter. The mandate of the Carter Commission was to undertake the widest possible inquiry into the Canadian tax system and, after holding hearings across the country and receiving more than 300 briefs, its 2700-page report was released in 1967. The report recommended the establishment of a comprehensive income tax base which would have included gifts, bequests, and capital gains realized or deemed to be realized, a complete integration of the personal and corporate income tax systems in the form of gross-ups and credits on dividends paid by Canadian corporations to Canadian-resident individuals, and the elimination of the exemption system on dividends received by Canadian corporations from foreign affiliates.[3] In summary, the Carter Commission had recommended a virtual transformation of the Canadian tax system.

The Carter report ran into immediate and concerted opposition, and the Government finally responded by issuing a White Paper on tax reform in 1969 in which many of the Commission's recommendations were diluted or abandoned. Following public debate and review of the White Paper by two parliamentary committees, proposed tax reform legislation was tabled in 1971 and an amended Income Tax Act was introduced effective 1 January 1972.[4] Notwithstanding a retrenchment from many of the recommendations of the Carter Commission, the amended Income Tax Act included substantive and far-reaching changes to the Canadian income tax system, such as the inclusion of one half of capital gains in the personal and corporate income tax base, integration of personal and corporate income tax in respect of dividends received from Canadian private corporations as prescribed, changes to the exemption system for foreign dividends paid out of active business income[5], and the introduction of accrual taxation for passive income earned by foreign affiliates of Canadian resident taxpayers.

III. OBJECTIVES OF THE CURRENT REFORM

It had been difficult to argue with the aims of 1971 tax reform – that the burden of taxation should be fairly distributed; that the tax system should not seriously interfere with economic growth and productivity; that a reasonably stable system should be put in place which would not undergo repeated change year after year.

Unfortunately, the ensuing years produced neither a simple nor a stable tax system. Successive Governments introduced a maze of tax preferences and incentives to encourage specific economic activities or to support certain regions or industries, and would then legislate countervailing measures to ensure that taxpayers did not make excessive use of these incentives. The years since 1972 saw more than 50 acts to amend the Income Tax Act, "mini-reforms" in 1974 and 1977 and an aborted reform in 1981, and numerous other changes in consumption, energy and provincial taxes. If anything, the rate and complexity of change had accelerated in recent months as beleaguered taxpayers and their advisors faced a dizzying series of proposals issued by the Department of Finance in the form of press releases, ostensibly to block various loopholes or perceived abuses by taxpayers. The requirement to reestablish some semblance of stability and order became clear.

There was other impetus for change. Personal income taxes had risen sharply over the years as a share of total federal tax revenues while consumption taxes and corporate income taxes had declined, and the Government felt that a better balance should be established. Also, the numerous tax preferences and incentives which had been introduced since 1972 had made the tax system a less predictable source of revenue. The federal sales tax system was felt to be antiquated and seriously flawed. Finally and perhaps most important, the United States had introduced a comprehensive tax reform in 1986[6] and it was generally felt that Canada's international competitiveness would suffer if Canada did not bring its personal and corporate

3. The Carter Commission recommended the substitution of the exemption system by an accrual system, whereby Canadian taxpayers having foreign direct investments would be taxable each year on remitted or unremitted foreign income at a rate sufficient to bring the combined Canadian and foreign tax burden to at least 30%.

4. SC 1970-71-72, c.63, as amended, herein referred to as the "Income Tax Act".

5. Prior to 1972, dividends received by a Canadian corporation from a non-resident corporation were exempt from tax in Canada, provided the Canadian shareholder held more than 25% of the issued voting shares. Under the present Income Tax Act, exemption applies to dividends received from "foreign affiliates" as defined (generally, a non-resident corporation in which the Canadian shareholder owns at least 10% of any class of shares either directly or indirectly), but is limited to dividends paid out of active business income of foreign affiliates in prescribed countries. Prescribed countries for this purpose are those listed in Regulation 5907(11) to the Income Tax Act, and generally include countries with which Canada has concluded an international tax convention or has commenced negotiations to conclude a convention.

6. The Tax Reform Act of 1986 was signed into law by President Ronald Reagan on 22 October 1986, and contained fundamental revisions to the U.S. tax system which were generally effective as of 1 January 1987.

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income tax rates closer in line with those of its major trading partner.

Notwithstanding the above, it is understood that, in the weeks leading up to release of the White Paper, Mr. Wilson had been under pressure from some members of his governing Conservative party to back away from a wholesale tax reform, particularly with the party running a poor third in public opinion polls and already facing major contentious issues, including constitutional accord with the Canadian provinces and free trade initiatives. While Mr. Wilson ultimately decided to proceed, the tax reform proposals are as previously noted less ambitious than had originally been expected. One result of this more modest approach is that efforts at simplification – one of the stated aims of tax reform – have essentially been abandoned.

IV. DETAILED ANALYSIS

A. Personal tax changes

The major thrust of personal tax reform is the reduction of personal income tax rates. Effective 1 January 1988, the existing 10 federal tax brackets will be reduced to 3 and tax rates will be lowered. The new structure of federal tax rates will be 17% on the first $ 27,500 of taxable income, 26% on the next $ 27,500 and 29% on any taxable income in excess of $ 55,000. The present 3% federal surtax will remain in place pending the implementation of sales tax reform. Commencing in 1989, the tax brackets will be indexed to any annual increase in the consumer price index in excess of 3%. Despite these proposed reductions in marginal tax rates, individuals resident in Canada will continue to bear a significantly higher tax burden than that borne by individuals resident in the United States.

The top personal marginal rates for each province, before and after the changes proposed in the White Paper, are shown in Table 1, using existing provincial income tax rates.

Table 1
Top personal marginal rates

Province	Top marginal rate* 1987	1988
Ontario	52.53%	44.81%
Quebec	56.57%	52.25%
British Columbia	52.53%	44.81%
Alberta	53.09%	45.43%
Saskatchewan	55.74%	47.79%
Manitoba	58.05%	49.53%
Newfoundland	55.42%	47.27%
Northwest Territories	49.64%	42.34%
Yukon	50.32%	42.92%
New Brunswick	54.74%	46.69%
Nova Scotia	54.23%	46.26%
Prince Edward Island	53.72%	45.82%

* Includes all surtaxes and other provincial taxes on income in effect or proposed as of 18 June 1987, including the 3% federal surtax.

A second feature of personal income tax reform will be the conversion of personal exemptions and a number of special deductions into tax credits. Under the existing system, the value of a personal exemption or deduction depends on a taxpayer's marginal tax rate, and is therefore greater for individuals in higher income brackets. Under the White Paper, tax credits would be a uniform amount for all taxpayers. Also, the exemption for dependants who are over age 18 and not infirm will be eliminated, as will be the standard $ 500 employment expense deduction.

Finally, the increased contribution limits to various retirement plans which had been proposed in October 1986 will be retained, but will be phased in more slowly than had been previously announced. Implementation of the new system will be delayed until 1989, and maximum retirement contributions will not be allowed until 1995. Deferral of the implementation date will be good news for employers, who are faced with increased reporting responsibilities under the new system. Employers will now have more time to make the necessary changes to accounting and payroll systems.

B. Corporate tax changes

In Mr. Wilson's Budget of February 1986, he outlined a major restructuring of the corporate income tax system to provide for a gradual reduction of corporate tax rates. Those proposals have now been abandoned in favour of the following corporate rate changes which are tied to a broadening of the corporate tax base:

- The basic federal rate will be reduced from 36% to 28%, generally effective 1 July 1988.[7]
- The federal rate on manufacturing income will be reduced from 30% to 23% by 1 July 1991.
- The federal rates of 15% for active business income eligible for the small business deduction, and 10% for small business manufacturing and processing income, will both be changed to a single rate of 12%, effective 1 July 1988.

The above rates are basic federal rates, and must be increased by the applicable provincial rate as well as the 3% federal surtax. The maximum combined federal-provincial corporate rate which will apply effective 1 July 1988 to non-manufacturing income will range from approximately 35% to 46%, depending on the province in which the business is carried on. These rates will generally continue to be higher than the applicable United States corporate tax rates. The comparative Canadian and United States corporate tax rates for the next two years can be summarized in Table 2.

7. For investment income including taxable capital gains of a Canadian-controlled private corporation (CCPC) as defined, the reduction of the basic rate from 36% to 28% will be advanced to 1 January 1988. This change is to accommodate the personal tax changes that are to become effective 1 January 1988. Together with the refundable tax mechanism for such corporations, this ensures continued integration of investment income between a CCPC and its shareholders.

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Table 2
Canadian and U.S. corporate tax rates

	1 July 1987 to 30 June 1988		1 July 1988 to 30 June 1989	
	Cdn.	U.S.	Cdn.	U.S.
General business	50.05%	40.6%	42.84%	40.6%
Manufacturing	42.84	40.6	40.78	40.6
Small business (Note 3)				
– General	28.42	28.9	26.36	28.9
– Manufacturing	22.24	28.9	26.36	28.9

Notes
1. Canadian rates are combined federal and provincial taxes assuming a 14% provincial rate. Federal surtax of 3% is included.
2. U.S. rates are combined federal and state taxes assuming a 10% state tax rate.
3. The U.S. small business rate is based on $ 100,000 of net income. U.S. federal corporate rates are graduated, with 15% charged on the first $ 50,000 of taxable income, 25% on the next $ 25,000 of taxable income, and 34% thereafter. The benefit of the lower marginal tax rates is recovered through a corporate surtax of 5% on taxable income between $ 100,000 and $ 335,000.

C. Capital gains and investment income

Capital gains

Under the present Income Tax Act, both individuals and corporations are required to include one half of capital gains net of capital losses in income. The White Paper proposes that the amount required to be included in income be increased to 66⅔% in 1988 and 75% in 1990.[8] The question of whether a particular receipt constitutes capital or income is generally determined based on the relevant facts, and not on any specific rules in the Income Tax Act; the White Paper does not propose any change in this regard, and disputes between taxpayers and Revenue Canada will therefore continue to arise in many situations.

A second change affecting capital gains involves a special exemption which was introduced for individuals in 1985. The exemption had a cumulative lifetime limit of $ 500,000 which was to be phased in over six years; for most individuals, the maximum exemption of $ 500,000 was to be reached in 1990. While the lifetime capital gains exemption is to be retained, the White Paper proposes a number of changes to this regime. First, the exemption will be limited to $ 100,000 for most assets. However, a $ 500,000 exemption will be available starting in 1988 for gains arising on the disposition of most shares of small business corporations as defined. The lifetime exemption for gains from qualifying farm property will also generally remain at $ 500,000. Finally, net taxable capital gains otherwise eligible for the lifetime capital gains exemption will be reduced by the amount of a taxpayer's cumulative net investment losses (CNILs) incurred after 1987. CNILs will include deductions claimed by individuals in respect of certain tax shelter arrangements, as well as interest expense and other net investment losses.

Dividend income

As a consequence of the reduction in corporate income tax rates, and to preserve the concept of integration of personal and corporate tax in the Canadian tax system, the dividend gross-up and credit applicable to individuals who receive Canadian dividends will be reduced from 33⅓% in 1987 to 25% in 1988. Notwithstanding the reduced dividend tax credit, the effective rate on dividend income will generally be lower after tax reform, having regard to reductions in general personal tax rates.

In the past, the rate of individual tax applicable to capital gains has been significantly lower than that applicable to Canadian dividend income, and this resulted in the introduction of rules in the Income Tax Act directed against "surplus stripping" by individuals. One consequence of the increase in the effective rate of tax applicable to capital gains and of the reduction in that applicable to Canadian dividends, is that the existing preference for capital gains will be removed, except where such gains can be sheltered from tax through the lifetime capital gains exemption or the application of net capital loss carry-overs.

Other proposals

Other proposals related to investment income include the following:

- The general $ 1,000 interest and dividend deduction available to individuals will be eliminated after 1987.
- New limitations will apply to capital cost allowance deductions on certified Canadian films acquired after 1987, and on multi-unit residential buildings acquired after 17 June 1987. Existing owners of multi-unit residential buildings may continue to create or increase a rental loss through capital cost allowance claims, but only for taxation years ending before 1991.

D. Business and property income

Capital cost allowance

Various base-broadening measures have been proposed in respect of business and property income, the most significant of which relate to changes in the rates

8. For individuals, 66⅔% would become taxable effective 1 January 1988 and 75% effective 1 January 1990. For corporations, the taxable portion would increase to 66⅔% for taxation years commencing after 30 June 1988 and 75% for taxation years commencing after 31 December 1989. For taxation years that straddle 1 July 1988 or 1 January 1990, the taxable proportion would be prorated based on the number of days in the year that fall on either side of the effective date. For companies that qualify as Canadian-controlled private corporations as defined, the 1 July 1988 effective date would be advanced to 1 January 1988 to correspond with both the personal and corporate tax rate reductions applicable to such corporations effective on that date. Corresponding changes will also be made in respect of intangible, capital assets such as goodwill and quota rights. The 50% ratio which applies at present to the purchase and sale of such assets will be increased to 75%, effective for fiscal periods commencing after 30 June 1988 for corporations and after 1987 for individuals and partnerships. In addition, the rate at which the qualifying portion of such expenditures may be written off for tax purposes will be reduced.

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at which assets are depreciated for income tax purposes (the capital cost allowance system). Certain of these rate changes will be phased in over a number of years and are subject to various transitional rules. The most significant proposal – both in terms of Government policy and of revenue raising potential – involves changes to the capital cost allowance rates for manufacturing and processing equipment. At present, most manufacturing and processing equipment is depreciable on a straight-line basis over three years, 25%-50%-25%. Under the White Paper, the rate would be changed to 25%, declining balance, subject to the general rule whereby only one half of the normal write-off is allowed in the first year (the half-year rule).

The major proposed changes to capital cost allowance rates are summarized in Table 3. In addition to these changes, it is proposed that the existing half-year rule be extended to special manufacturing tools presently eligible for full write-off in the year of acquisition.

Table 3
Proposed changes to capital and allowances

	Current rate[1]	*Proposed rate*[1]
Most manufacturing machinery and equipment	50% straight line	25% declining balance[2]
Certain manufacturing machinery and equipment otherwise included in Class 10 (industrial lift trucks, portable rental tools, certain data processing equipment and systems software)	50% straight line	30% declining balance[3]
Resource extraction assets	30% declining balance (plus immediate write-off up to income from new mine)	25% declining balance (plus immediate write-off up to income from new mine)
Drillships and offshore platforms	30% declining balance	25% declining balance
Earth-moving equipment	50% declining balance	30% declining balance[3]
Buildings	5% declining balance	4% declining balance
Satellites	40% declining balance	30% declining balance
Outdoor advertising signs	35% declining balance	20% declining balance
Certified Canadian films	100%	30% declining balance (plus immediate write-off up to film income)
Public utility property	6% declining balance	4% declining balance

Notes:
1. All rates expressed before taking account of "half-year rule".
2. To be phased in as follows (with proration for non-calendar fiscal years): 1988-40%; 1989-35%; 1990-30%; thereafter, 25%.
3. To be phased in as follows (with proration for non-calendar fiscal years): 1988-40%; 1989-35%; thereafter, 30%.

In addition to the above, a new "put in use" rule will apply to property acquired after 1989 for purposes of determining the year in which capital cost allowance and any related investment tax credits may first be claimed. Under this rule, no deductions or credits will generally be available until the earlier of the year in which an asset is put in use and the year in which the construction of an asset by or on behalf of the taxpayer is completed.

Investment tax credits

The general investment tax credit applying to most assets will continue to be phased out by 1989, while the investment tax credit for research and development expenditures remains unchanged. Other investment tax credits will be reduced in line with reductions in corporate tax rates. Investment tax credit rates under the White Paper may be summarized as in Table 4.

Table 4
Investment tax credit

	1987	*1988*	*1989*
Qualifying buildings and equipment			
– general	5%	3%	0%
– designated areas	7%	3%	0%
Depreciable manufacturing and processing property in prescribed areas	40%	40%	30%
Research and development	(*)	(*)	(*)
Atlantic region	20%	20%	15%
Cape Breton	60%	60%	45%
High-cost exploration	25%	25%	25%

* Unchanged from current rates of 20%, 30% and 35%, depending on location and size of firm.

A number of other changes have been proposed to the rules related to investment tax credits. Most important, the amount of such credits that can be applied in any year will generally be limited to 50% of federal taxes otherwise payable, effective for taxation years ending after 1987.[9]

Other proposals

There are a number of other proposals affecting business and property income. These include the following:

- While existing tax incentives for qualifying scientific research and experimental development will largely be maintained, buildings acquired after 1987 and used for research and development will generally no longer be eligible for either immediate deduction or for investment tax credits.
- New rules will reduce the deductibility of expenses of owning and running automobiles. In particular, for most passenger automobiles purchased or

9. In the case of individuals, unincorporated businesses and Canadian-controlled private corporations eligible for the small business deduction, this limit will be somewhat increased to the aggregate of $24,000 and 50% of federal tax in excess of $24,000.

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leased after 17 June 1987, capital cost for depreciation purposes will be limited to $ 20,000 (with a corresponding limit for leased vehicles).

- Deductions for most business meals and entertainment expenses incurred after 1987 will be limited to 80% of their actual cost.
- Construction period soft costs and vacant land carrying costs incurred by land development companies will be required to be capitalized after 1987, subject to a five-year phase-in period. In addition, vacant land carrying costs incurred by other taxpayers will be required to be capitalized where the land is held in, but not used in, the course of a business (for example, carrying costs related to vacant land held by a manufacturer for future expansion).
- Expenses incurred after 1987 to issue shares, trust units and partnership interests will be required to be amortized over five years, and expenses incurred to borrow funds will be amortized over the greater of five years and the term of the debt.
- A number of changes will be made to the tax treatment of financial institutions and insurance corporations which will significantly increase the tax burden in those industries. These proposals include changes to the calculation of insurance and loan loss provisions and reserves, and the imposition of a special tax of 15% on investment income of life insurance companies. In addition, changes will be made to the calculation of the amount of investment income of a Canadian-resident multinational life insurance corporation or of a non-resident insurance corporation that is brought into the Canadian tax base.
- Under existing rules, taxpayers are generally entitled to an immediate deduction for the full amount of any Canadian exploration expenses and, in addition, bonus deductions are allowed in the form of mining exploration depletion and earned depletion deductions amounting to 33⅓% of the amount of qualifying expenditures. The White Paper proposes that the earning of depletion entitlements be phased out by 30 June 1989; in addition, grants under the Canadian Exploration and Development Incentive Program for oil and gas exploration are to be phased out over approximately the same time period. The Government has indicated that it will consider appropriate non-tax assistance to encourage major oil and gas projects and tertiary recovery projects. Other changes to the taxation of the natural resource industries include an extension of the limited partnership "at-risk" rules to resource expenditures.

E. Preferred share financing

Preferred shares have been an attractive form of financing for Canadian corporations which pay little or no tax. Such corporations would not have been able to make immediate use of interest deductions had they financed by way of debt. However, where such corporations have used this form of financing, the granting of tax relief to the shareholder (through either the dividend tax credit or the intercorporate dividend deduction available to individuals and corporations respectively) results in a perceived loss of current tax revenue to the Government. To counteract this loss of revenue, it is proposed that, with respect to dividends paid after 1987 on most preferred shares ("taxable preferred shares") issued after 18 June 1987, a special tax be paid by the payor company.

A corporation paying a dividend on a taxable preferred share will have the choice of paying either a 25% or 40% tax on the amount of dividends paid. If the payor pays tax at the 25% rate, an additional 10% tax may be payable by the recipient shareholder, if the recipient is either a specified financial institution or a public corporation as defined. On the other hand, if the payor corporation elects to pay the 40% tax, no further tax will be payable by the recipient under any circumstances.

An offset mechanism will be provided under which the payor corporation will be entitled to a deduction in computing taxable income equal to 5/2 of the tax payable. For corporations which currently pay tax, this should result in a tax reduction approximately equal to the special tax on the taxable preferred share dividends. However, for non-taxpaying corporations, this reduction in taxable income will provide no immediate tax relief. Preferred share financing will therefore be far less attractive for these companies than it has been in recent years.

The special tax will generally not apply to dividends of up to $ 500,000 on taxable preferred shares paid annually by a corporation or by an associated group of corporations,[10] to dividends paid to a related shareholder or to a shareholder that owns 25% or more (by votes and value) of all issued shares of the payor corporation, or to dividends paid by certain prescribed corporations (basically financial intermediaries).

There are a number of other proposed changes related to preferred shares. Dividends received after 1987 by specified financial institutions as defined on preferred shares may be subject to a special 10% tax, even if the shares were issued before 19 June 1987. In addition, preferred shares issued after 18 June 1987 may constitute short-term preferred shares, with consequent denial of the intercorporate dividend deduction, if they are retractable or are required to be redeemed within five years of their issue date (rather than 18 months, as at present).

These new preferred shares rules will rival the most complex provisions found in the Income Tax Act, and their introduction belies the fact that simplification was one of the stated aims of tax reform. In addition, there appear to be a number of technical problems

10. So as to exclude larger corporations from any exemption, this $500,000 exemption will be reduced by the amount, if any, by which dividends paid in the immediately preceding calendar year exceed $1 million.

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with the proposals as presently drafted – for example, the transfer of "mainstream tax" to advance corporation tax may adversely affect the foreign tax credit position of corporations which are in taxable positions – and further changes to the proposed rules can therefore be expected.

F. Tax avoidance

In the 1984 Stubart decision,[11] the Supreme Court of Canada concluded that the lack of a bona fide business purpose was not sufficient basis, in and of itself, to disregard a transaction for Canadian tax purposes. Rather, the Court indicated that a transaction might be defeated where it fell outside the "object and spirit" of the tax statute taken as a whole, and that business purpose may be relevant in considering the possible application of specific anti-avoidance provisions in the Income Tax Act.

The Government evidently believed that, having regard in part to the Stubart decision, the existing provisions of the Income Tax Act were not adequate to deal with a number of tax avoidance arrangements, and the White Paper has proposed the introduction of a broad new anti-avoidance measure which will contain "bona fide business purpose" and "step transaction" tests.

The new rule would provide that an avoidance transaction, as defined, be ignored for tax purposes, and that a taxpayer's tax position be determined as if the transaction had not occurred. An avoidance transaction would be defined to include any transaction that results in a significant reduction, avoidance, deferral or refund of tax, unless that transaction may reasonably be considered to have been carried out primarily for bona fide business purposes. An avoidance transaction would also include any transaction ("a step transaction") which is part of a series of transactions that results in a significant reduction, avoidance, deferral or refund of tax, even though the specific step by itself may not result in a significant reduction of tax. Unless the particular step can reasonably be considered to have been carried out primarily for business purposes, it may constitute a tax avoidance transaction, which would be ignored in determining the income tax implications of the transaction.

If a transaction is found to be an avoidance transaction, Revenue Canada would have the power to determine the tax consequences on a basis that he considers reasonable in the circumstances. In the event that the Minister exercises his power under the provision, taxpayers would have the right to appeal to the Courts, based both on the Minister's determination of the lack of business purpose and on his determination of the tax consequences arising therefrom.

The White Paper indicates that, if this rule is enacted, certain other tax avoidance provisions already in the Income Tax Act are to be reviewed with the intention of either eliminating them or making them more effective. No implementation date has been set for this new proposal, and it is understood from discussions with the Department of Finance that the proposal would not become effective at least until draft legislation is introduced later this year.

The proposed rule has potentially wide application to ordinary business transactions that may be structured in different ways with correspondingly different income tax implications to the various parties involved, and the rule will certainly be the subject of considerable debate and discussion. Uncertainty in the application of the provision would make it necessary for taxpayers and their advisors to be exceedingly cautious in carrying out business transactions, and to seek binding advance rulings from Revenue Canada in many situations.

In the 1984 Stubart decision referred to above, the Supreme Court of Canada set out a well-reasoned set of interpretative guidelines. The author would question whether these guidelines, together with certain modifications to existing anti-avoidance provisions already in the Income Tax Act, should not have been sufficient ammunition for Revenue Canada, and whether the proposed anti-avoidance rule set out in the White Paper is not a somewhat unwarranted response to the Stubart decision. In any event, it is to be hoped that the full implications of the White Paper proposal will be explored in the consultations the Government holds on tax reform and that, before a rule of this type is implemented, there be a clear understanding by Revenue Canada and taxpayers as to its application, so that it does not interfere with normal business activity.

G. Administration and compliance

The White Paper proposes a number of changes involving administration and compliance, most of which involve additional reporting requirements and increased penalties. These changes will include reporting requirements on the part of investment dealers and financial institutions with respect to sales by their clients of shares, commodities or other investments, and an acceleration in remittance by larger corporations of employee source deductions. Also, certain provisions in the Income Tax Act will be revised so as to increase the penalties charged for violations, convert certain fines previously payable on summary conviction to automatic penalties, and impose higher penalties on second-time offenders.

In addition to the above, there are three proposals specifically related to international transactions. First, it is proposed that Revenue Canada be authorized to require the production of foreign-based information relevant to the Canadian tax treatment of a transaction. This rule will be similar to the formal document request found in Section 982 of the Internal Revenue Code of the United States and Section 21A of the New Zealand Inland Revenue Department Act, 1974. It is anticipated that a taxpayer will be entitled to challenge

11. *Stubart Investments Limited vs. the Queen:* 84 DTC 6305; (1984) CTC 294.

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such a request before the Courts if it has reasonable cause.[12]

A second initiative with respect to international transactions is the proposed introduction of an information form which would be required to be filed by corporations carrying on business in Canada, providing details of cross-border transactions with related parties. The form would be similar to U.S. prescribed form 5472.[13]

The final administrative change related to international transactions involves the statutory limit for issuing reassessments. The general statutory limit in this regard is 3 years from the date that an original notice of assessment (or notification that no tax is payable) is issued for a given taxation year. The White Paper proposes that this limit be extended in the case of reassessments of cross-border transactions, but does not indicate what the extension period might be.

H. Commodity tax

As part of the tax reform package, details concerning plans to reform the existing federal sales tax system were released. In the Government's view, a multi-stage sales tax applied at a uniform rate on a broad base, together with refundable sales tax credits,[14] would be more neutral and fair than the current federal sales tax system and could be accommodated with a reduced cost of compliance and administration.

Current federal sales tax system

Federal sales tax is currently applied to the manufacturer's sale price of goods produced or manufactured in Canada and to the duty paid value of goods imported into Canada. With limited exceptions, federal sales tax does not apply to services. The general rate of tax is 12%, while a reduced rate of 8% applies to certain construction materials and equipment for buildings. A 15% rate applies to liquor, beer and tobacco products. The current system provides exemption from tax for a variety of goods such as food, clothing, footwear and prescription drugs.

The system is perceived to the flawed because of its narrow base, differing effective tax rates depending upon the distribution channels through which goods flow, its adverse impact on investment and exports, and its bias in favour of imports. It is estimated that about 50% of the total federal sales tax collected is derived from business inputs. This can result in double taxation or cascading since the inputs are frequently used for the production of goods which are themselves subject to tax. Further, exported goods, which are intended to be free of tax, are saddled with this indirect tax content.

Perhaps the most serious flaw in the existing system is that it favours imports over domestically manufactured goods. Imports are taxed at the border on their duty paid value, i.e. prior to incurring marketing, selling and distribution costs in Canada. In most cases, these costs are included in a domestic manufacturer's tax base. In an effort to remove this bias towards imports, the Government has been gradually shifting the level of taxation from the manufacturer's level to the wholesale level for a variety of goods.

To address the deficiencies of the existing federal sales tax system, the Government proposes to replace it with a broadly based multi-stage sales tax system extending to the retail level.

Multi-stage sales tax

A multi-stage sales tax would be applied on value added, levied on and collected from all businesses as goods move through various production and distribution chains to the consumer in Canada. Under this type of system, businesses would pay tax on their sales and claim a credit for any tax paid on their purchases.

In his White Paper, the Minister outlined three possible methods of implementing the multi-stage sales tax:

- a *national sales tax*, replacing both the current federal sales tax and existing provincial retail sales taxes;
- a federal-only *goods and services tax*; and
- a federal-only *value-added tax*.

The Minister's preference would be a national sales tax, and preliminary discussions have taken place with the various provincial governments. If such a national system could be agreed to, the rate applicable in a province would be the sum of a uniform federal rate and the particular rate set independently by the provincial government. Because of this, it is likely that the national sales tax rate would vary from province to province.

With a federal goods and services tax, a uniform federal tax would be levied on virtually all goods and services in Canada. Provincial retail sales taxes would continue as independent levies. Because the base would be comprehensive, separate tax calculations on each invoice would not be required. A business could calculate its tax liability for a period from its books of account. It is contemplated that such a system would not exempt many products or sectors of the economy. This, it is intended that a goods and services tax would be accompanied by a substantially enriched refundable sales tax credit for lower and middle-income Canadians.

The third choice – a federal value-added tax – would involve the explicit invoicing of tax. Because the tax would be invoiced, it could be more selectively applied. Tax payable on sales would be reduced by tax incurred on taxable purchases to determine the business' liability for tax. The extent to which the refund-

12. Note however that, under Section 982 of the U.S. Internal Revenue Code, the fact that disclosure of information would contravene foreign law and result in civil or criminal penalties does not constitute reasonable cause.

13. Form 5472 ("Information Return of a Foreign Owned Corporation") is required under Section 6038A of the U.S. Internal Revenue Code.

14. To address in part the regressive impact of a greater reliance on consumption based taxes, the White Paper proposes increases in refundable credits in the personal income tax system.

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able sales tax credit would be enhanced would depend on the breadth of the base.

The Minister has not indicated the intended rate of federal tax under any of the systems, although an 8% rate is used for illustrative purposes. Determination of that rate will depend on the system chosen, on the extent of exemptions and special rules and on revenue requirements. On the latter point, Mr. Wilson has indicated that revenue from the new system should be sufficiently greater than that of the present, so as to permit elimination of the personal and corporate income tax surtaxes, to provide further income tax reductions to middle-income Canadians, and to fund further enriched refundable sales tax credits to lower and middle-income Canadians.

Interim sales tax measures

The White Paper documents make no mention of the specific implementation date for sales tax reform. It is likely that, once a firm decision has been made as to the option chosen, at least one full year will be needed for implemention. It therefore appears that sales tax reform will not be in place until at least 1990. Pending the introduction of sales tax reform, the Government has announced a number of measures in the context of the existing sales tax system which, together with the corporate tax changes, are intended to provide the additional revenues required to proceed with personal income tax reform. Over the next four fiscal years, these sales tax changes are forecast to generate additional revenue of $4.8 billion. Over 80% of these additional revenues are to come from a new 10% tax which will be imposed commencing 1 January 1988 on virtually all telecommunication services with the exception of the basic line charge for local residential telephones. Other changes, also effective in 1988, will involve rate increases, or shifts from the manufacturer level to the wholesale level, for a number of products, and the introduction of rules affecting the application of tax to marketing companies related to the manufacturer.

V. CONCLUDING COMMENTS

As noted above, the Canadian tax reform proposals are less pervasive than had been expected, and clearly represent a compromise on the part of the Finance Minister. While there has been some base-broadening and reduction of personal and corporate income tax rates, the existing income tax system has generally not been disturbed, and there has been no real attempt to redress the excessive complexity contained in the Income Tax Act. Measures which might have contributed significantly to simplicity and fairness (such as the taxation of the full amount of capital gains at the same rate as ordinary income, and the repeal of the lifetime capital gains exemption for individuals) have not been proposed. Neither have there been any dramatic new initiatives to encourage Canadian business activity in general or foreign investment in particular.[15] At the same time, stage two of tax reform – the reworking of the sales tax system – does promise to be more far-reaching.

What does appear certain is that the Canadian tax reform process is far from over, and the Canadian taxpayers will continue to face frequent and substantive change on an ongoing basis. As so often seems to be the case, the more things change, the more they remain the same.

15. For example, a welcome measure might have been a general repeal of Canadian withholding tax on interest payments for portfolio debt held by non-related foreign investors.

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THE NETHERLANDS ANTILLES:

The New Ship Registration Tax Act

By G.C.A. Smeets

INTRODUCTION

In its meeting of 3 September 1987 the Parliament of the Netherlands Antilles[1] ratified a new law: the "Landsverordening op de Scheepsregistratiebelasting".[2] With my apologies for this tongue-twister, I will refer to it simply as the "Act".

The Act makes it possible for Netherlands Antilles shipping companies to pay a fixed annual tax per ship registered in the Netherlands Antilles, *in lieu* of taxes on profit. With this Act, the Netherlands Antilles are making a determined effort to attract a larger share of the world's shipping tonnage to its registers.

Before the Act, Netherlands Antilles law already contained, in Art. 9A of the Profit Tax Ordinance 1940 (Landsverordening op de Winstbelasting), special provisions for the taxation of companies operating shipping or air services. Art. 9A provides for a low tax rate of effectively 7.7% to 9.6% of the taxable profits, after application of generous provisions for investment allowances, creation of and allocation to reserves, accelerated depreciation and loss carry-forward.[3]

Although Art. 9A has proven to be attractive to many shipowners, it is felt that most shipowners prefer a simple system of taxation that adds the tax as a fixed amount to their cost of operations.[4] And, looking at Art. 9A through the eyes of the Government, the state of affairs in international shipping is presently such that revenues from a tax based on profits made in shipping are likely to be, to put it mildly, disappointing. For both shipowners and Government a tax on tonnage rather than on profit should be more attractive.

The Act therefore introduces an annual tonnage tax, levied on the ships listed in a new Register of Taxable Ships, which is (with one exception) at the option of the ship's owner. Should the owner opt for the tonnage tax, he will be exempt from the profit tax, and vice versa.

In the following discussion of the Act, we will simply follow the sequence of its Articles and discuss the issues as they may arise in that sequence.

DEFINITIONS

Art. 1 of the Act gives certain definitions for the application of the Act, the most important of which are:

A *registered ship* is a ship[5] listed in the Register of Netherlands Antilles Ships.

A *taxable ship* is a ship listed in the Register of Taxable Ships.

Thus, there are now two ships' registers in the Netherlands Antilles:

(1) The Register of Netherlands Antilles Ships[6] is a public register for the recording of ownership of ships, ships' mortgages and the like. In this register all Netherlands Antilles ships are registered. To be eligible for listing in the Register of Taxable Ships, a ship must first be listed in the Register of Netherlands Antilles Ships, and to be listed in that register, the ship must be of Netherlands Antilles ownership[7] or, rather, Dutch nationality. In this connection it should be noted that there does not exist a Netherlands Antilles nationality. Being part of the Kingdom of the Netherlands, citizens and ships of the Netherlands Antilles have Dutch nationality and the ships fly the Dutch flag.

(2) The Register of Taxable Ships, established by Article 7 of the Act, is maintained solely for purposes of tax administration, listing in which is at the option of the owner of the ship.

THE TONNAGE TAX

Art. 2 of the Act establishes the ship's registration tax (we will refer to it as the "tonnage tax") as an annual tax on the gross tonnage of taxable ships (ships listed

1. The Netherlands Antilles are a self-governing part of the Kingdom of the Netherlands and consist of the islands Curacao, Sint Maarten, Bonaire, Saba and Sint Eustatius. The island Aruba, formerly a part of the Netherlands Antilles, became on 1 January 1986 in its own right a self-governing part of the Kingdom, so that now the Kingdom of the Netherlands consists of three main political subdivisions: the Netherlands, the Netherlands Antilles and Aruba. The Act applies only to the Netherlands Antilles and not to Aruba.
2. Freely translated as: "Land's Ordinance on the Ship's Registration Tax".
3. See my article in the *Bulletin for International Documentation*, Vol. XXVI, August 1972, which is still up to date, except that the guarantee referred to on page 312 has been extended to 1996, and that the period during which investments can be made qualifying for the investment allowance, has been extended to the year 1996.
4. In addition, Art. 9A penalizes the owner who sells his ship within ten years after claiming the investment allowance (see page 315 of my article referred to in note 3).
5. "Ships" are defined in Art. 2 of the 1933 Curaçao Decree concerning Sea Letters (reading: this Decree considers as Oceangoing vessels all ships, including coasting ships, which are used for navigation on sea or which are designed therefor, with the exception of (a) warships; (b) ships of sailing clubs or of yachtclubs, recognized as such by the Governor; (c) salvage vessels; and (d) vessels measuring less than twenty cubic meters gross. . . . . .).
6. Established by Art. 378 of the Code of Commerce.
7. The Netherlands Antilles Government is presently studying the possibility of registration of foreign owned vessels in bare boat charter to Netherlands Antilles companies. This would make "dual registration" possible.

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in the Register of Taxable Ships), and Art. 3 establishes the amount and calculation of the tax.

The *amount of the tax* is 40 Netherlands Antilles cents per gross register ton[8] or about US$ 0.22[9] per ton with a minimum of 1,000 NAf or about US$ 556 per ship. For calculating the tax, the tonnage is rounded off upward in thousands of tons,[10] and the tax itself is rounded off upward in hundreds of guilders.[11]

Compared with some other countries that tax their shipping on the basis of tonnage, the Netherlands Antilles tonnage tax is somewhat higher[12] and is further calculated on the gross tonnage rather than net tonnage. On the other hand, there is *no first registration tax* or fee. To the contrary, at first registration the annual tax for the first year is prorated to the number of months remaining in the year, including the month of registration.[13] This discrepancy is intentional and means to offer a true alternative to other countries: in many cases it may be attractive to accept a somewhat higher annual tax in return for a substantial reduction in first time registration fees.

When a ship is deregistered (from the Register of Taxable Ships) the tax for the current year (which is paid in the beginning of the year, see below), is not reduced or returned to the taxpayer.[14]

An interesting provision in Art. 3 is a *guarantee against possible increases of the tax.* By decree the amount of the tax per ton and the minimum per ship can be changed, however, any increase of the tax does not affect ships already listed in the Register of Taxable Ships.[15] A decree, which is issued by the Governor and the Council of Ministers, is a more flexible instrument than an ordinance, which involves the Governor, the Council of Ministers and Parliament. Thus, if after gaining more experience with the tax or when circumstances change the tax should be considered too high or too low, it can easily be changed to a more appropriate amount, without adversely affecting ships already registered.[16] In theory it would still be possible to change the amount of the tax by ordinance, but in view of the existing, more flexible instrument of a decree and the protection clearly intended by Art. 3, that would be very unlikely.

Exemption

The Profit Tax Ordinance 1940 subjects the profits of a variety of Netherlands Antilles corporations to the profit tax. Art. 4 of the Act provides that, under certain conditions, shipping companies are not subject to the profit tax. This is farther reaching than just an exemption. Indeed, the shipping company is not only exempted from the profit tax, but is also not required to fulfil the formalities of the Profit Tax Ordinance, such as filing annual tax returns.

Conditions

The conditions are that all ships registered in the name of the company in the Register of Netherlands Antilles Ships are also registered in the Register of Taxable Ships, and that the business of the company is exclusively or almost exclusively the shipping business.[17]

Charterers

The exemption from profit tax, or rather, the provision that the Profit Tax Ordinance 1940 does not apply, is also valid for Netherlands Antilles companies chartering[18] taxable ships.[19] As with the owners of taxable ships, the conditions are that the business of the company is exclusively or almost exclusively the shipping business and that all ships registered in the Register of Netherlands Antilles Ships and owned or used by the company, are taxable ships.[20,21]

Exclusive shipping business

The use in the law of the words "exclusively" or "almost exclusively" make it clear that the company is not subject to the Profit Tax Ordinance if it should operate a different business as a minor side-line to its shipping business. The profits of such side-line are equally exempt from the profit tax since the exemption from the Profit Tax Ordinance applies to the company as such, and not to its shipping business. Perhaps superfluously, we should mention that having another business incidental, or in furtherance of the shipping business (e.g. a tour operation in connection with the cruise ship business) and subject to the principal shipping business of the company, does not violate the "exclusive" condition. Equally, investment of surplus funds does not violate that condition.

Definition of shipping business

Shipping business is in the Act broadly defined as any lawful use of ships or vessels, whether self-propelled or not.[22] Exceptions are made for regular services exclusively between the harbours of the Netherlands Antilles; irregular services between harbours of the Netherlands Antilles (except when on an occasional basis); and fishing or other use of vessels within the Antilles territorial waters (except when on an occasional basis).

8. Paragraph 1 of Art. 3.
9. The Netherlands Antilles guilder, abbreviated NAf, is pegged to the U.S. dollar at 1.80 NAf to the dollar. The guilder is divided into one hundred cents.
10. Paragraph 2 of Art. 3.
11. Paragraph 4 of Art. 3.
12. Paragraph 3 of Art. 3.
13. E.g. Panama with $ 0.10 per net register ton.
14. Paragraph 5 of Art. 3.
15. Paragraph 6 of Art. 3.
16. A decrease of the tax, of course, will benefit ships already listed.
17. Paragraph 1 of Art. 4.
18. Or using taxable ships under any other title.
19. Paragraph 3 of Art. 4.
20. The requirement is that all *Netherlands Antilles* ships owned or used by the Company are taxable ships. The company may thus operate a mixed fleet of Netherlands Antilles and foreign vessels.
21. Nor is the charterer liable for the tonnage tax. For that tax the owner is liable.
22. Paragraph 2 of Art. 4.

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SWITCHING BETWEEN TONNAGE TAX AND ART. 9A

The mere fact of the continued registration of ships in the Netherlands Antilles sufficiently demonstrates that the owners of these ships are satisfied for their particular purposes with the existing facilities of Art. 9A. For the Netherlands Antilles, there would be no good reason to deny the existing facilities, not for the existing owners, nor for future owners who might prefer the facilities existing right now.

For this reason, it was decided to make it optional to the owner of a vessel to choose between the profit tax system of Art. 9A and the system of the tonnage tax.

With this philosophy, a shipowner should also be allowed to change regimes. Within certain limits, however, otherwise a company when making profits would change from profit tax to tonnage tax, and when making losses, change back to the profit tax. While for the shipowner this might be the best of two worlds, the Governments' lack of enthusiasm for this possibility needs no further explanation.

Therefore, Art. 5 of the Act stipulates that a company changing from the profit tax to tonnage tax should first value its ships at true value, and the investment allowances[23] to its profit and loss account as well as the reserves made under Art. 9A of the Profit Tax Ordinance, and then pay the profit tax on the resulting profits, if any.

This still allows a company in a loss situation to change from tonnage tax to profit tax. A result considered acceptable because first, the Government sympathizes with companies making losses[24], and second, once under the Profit Tax Ordinance, the company cannot change back to the tonnage tax without first surrendering the advantages obtained under Art. 9A of the Profit Tax Ordinance.

VOLUNTARY LISTING IN REGISTER OF TAXABLE SHIPS – EXEMPTION

In order to qualify for listing in the Register of Taxable Ships, the ship should be a registered ship within the meaning of the law, that is, be a ship registered in the Register of Netherlands Antilles Ships. A qualifying ship is listed in the Register of Taxable Ships at the request of the owner, that is the corporation in whose name the ship is registered in the Register of Netherlands Antilles Ships.[25]

Ships older than 15 years

An additional requirement for ships older than 15 years is a certificate by the Netherlands Antilles Shipping Inspector that the vessel complies with safety regulations and other requirements as "above standard".[26] In general, the requirements for registration as a Netherlands Antilles vessel are such, that this provision is not really needed. The Act, however, is a tax law to be applied and used by the tax authorities who simply like to be assured by the Inspector of Shipping that they are not opening the gates to the Netherlands Antilles for undesirable ships.[27]

Pleasure craft

An exception to the voluntary character of listing in the Register of Taxable Ships, is the provision that the Inspector of Taxes is authorized to list pleasure craft that are not used in a business.[28] In the past, several yachts have been registered in the Netherlands Antilles, attracted by the fact that inspection and registration costs are low, that there are no annual registration fees and that, not being commercially used, there are no taxable profits and, hence, no taxes at all. Such yachts can be listed by the Inspector of Taxes and thus made taxable ships.[29]

PROCEDURES

Assuming the ship is already registered as a Netherlands Antilles ship[30], the procedure for listing in the Register of Taxable Ships is straightforward. A request is filed with the Inspector of Taxes, together with statements by the Shipping Inspector, concerning the size of the ship, and by the Ships' Registrar concerning the owner of the ship.[31] Easy to use forms, combining the request and the two statements on one sheet of paper, have been determined by the Director of Taxes.[32]

The procedures for reporting changes, including change of owner, and deletion of the listing are equally straightforward.

Upon receipt of the proper and properly completed form, the listing, change or deletion, is immediately effected. When the ship is sold to another Netherlands

23. To the extent the allowance has been claimed within ten years of the change-over.
24. We avoided the words "fully sympathizes". To the draft Act presented to it by the private sector, the Government added the provision that a change-over from tonnage tax to profit tax is not allowed in the first five years of listing, unless the ship is sold or lost.
25. Paragraph 1 of Art. 6.
26. Paragraph 3 of Art. 6.
27. While the draft of the Act was circulated within the private sector for its comments, the "15-year old provision" was challenged from some sides. I trust that the defence given here is satisfactory.
28. Paragraph 2 of Art. 6.
29. This provision was also challenged from some sides of the private sector. However, yachts will because of their smaller size seldom if ever be subject to more than the 1,000 NAf minimum tax, and in my opinion that should be a reasonable compensation for the advantages of low inspection costs and the luxury of the Netherlands flag on the stern. In addition, the yachts are not automatically listed, and the Inspector can use his authority to make exceptions in cases where listing is not justified.
30. The procedure for registration as a Netherlands Antilles ship is not within the scope of this article. A brief outline: required are a bill of sale, a certificate of measurement according to the Aisle Convention, and a declaration by the Judge in First Instance that the ship satisfies nationality requirements. On the basis of these documents, the ship is registered.
31. Art. 7.
32. Art. 12 authorizes the Director of Taxes to prescribe forms for first listing, reporting changes and deletion of listing.

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Antilles corporation, both former and new owner are authorized to report the change of ownership.[33]

One exception has already been noted: *deletion* of the listing is not possible within the first five years of listing, unless the ship is sold or lost.[34]

LIABILITY FOR AND PAYMENT OF THE TAX

The taxable year, as already evident from the prorated tax for the first year, is the calendar year.[35]

The owner, as recorded in the Register of Taxable Ships per the first day of the taxable year, is liable for the tax, even should he at that date no longer actually own the ship.[36]

The owner of the ship is required to file a return with the Receiver of Taxes within the first two months of the taxable year.[37] In the first year, the return must be filed within 15 days after listing.[38] The tax must be paid while filing the return.[39] The Tax Inspector nor the Receiver of Taxes is required to send an assessment for the tax, it is the taxpayer's responsibility to file and pay on time.

Together with the owner, the managing directors, managing partners and other representatives in the Netherlands Antilles, if any, are severally liable for the tax, in addition to the ship's husband, if any.[40] This is not as unreasonable as it may appear:[41] the tax is for a predetermined amount, payable in advance, and, should the owner fail to pay within the two months period, the persons made severally liable are in a position to resign before that period has lapsed.

When the ship is sold, both former and new owners are severally liable for the tax for the current year and the immediately past year.[42] Inquiry at the Register of Taxable Ships about any outstanding taxes should therefore become part of the normal search for title.

CONCLUDING REMARKS

To the draft of the Act, presented to the Government by the private sector, the Government added a curious provision. This is that as penalty for non-payment, the Inspector is authorized to delete the listing of the ship in the Register of Taxable Ships. In that case, the vessel is deemed never to have been listed![43] The result could be that not only the owning company but also the charterers and former owners retroactively become subject to the profit tax. This undesirable result was obviously not foreseen and the strict interpretation given here is patently impossible to hold. There can be no doubt that former owners and charterers will be unaffected by the default of the present owner. Even so, in my opinion, the provision should be deleted from the Act. The other securities that the Government has for payment of the tax are already abundantly sufficient. And it puzzles me, if the Government cannot collect the tonnage tax, how it envisions to collect the vastly more complex profit tax.

33. Paragraph 3 of Art. 11.
34. Art. 10.
35. Art. 13.
36. Art. 11. For the first year the corporation requesting listing is liable for the tax.
37. Paragraph 1.a of Art. 15.
38. Paragraph 1.b of Art. 15.
39. Paragraph 1 of Art. 14.
40. Paragraph 3 of Art. 16.
41. From several sides in the private sector objections were made to this provision.
42. Paragraph 3 of Art. 11.
43. Paragraph 2 of Art. 15.

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UNITED KINGDOM:

Hidden Distributions of Profit

By K.E. Etherington

Most countries, understandably, need legislation to prevent the hidden transfer of profit to other countries where tax rates are lower. The United Kingdom is no exception. This paper examines legislation concerned with inter-company pricing. It then goes on to look at the problem of thin capitalization and the relationship of U.K. law in the area of both thin capitalization and inter-company pricing to double taxation agreements generally. Finally, the special position of permanent establishments is briefly examined. The emphasis under U.K. law is on the adjustment of transfer prices and the principal piece of legislation is S.485 Income and Corporation Taxes Act (ICTA) 1970.

S.485 ICTA 1970

S.485 deals with transactions between associated persons where either the buyer, being a body of persons, is controlled by the seller, the seller being a body of persons, is controlled by the buyer, or some other person controls both the buyer and the seller. Body of persons includes a partnership, but I shall assume for the purpose of this paper that we are talking about a company. S.534 ICTA 1970 defines control for the purposes of S.485 as the power of a person to secure that the affairs of a company are carried out in accordance with that person's wishes. This could be brought about either by the holding of shares or the possession of voting power or by virtue of powers conferred by the articles of association or other document regulating that or any other company.

The transactions covered by the Section include the sale or purchase of any property where the price is different to that which might have been expected if the parties had been independent persons dealing at arm's length. Although the Section heading refers to sales etc. at undervalue or overvalue, in the case of a seller it applies only where the price charged is lower than the arm's length price and in the case of a purchaser only where the price charged is higher than the arm's length price. The Section is not, therefore, of assistance in adjusting prices where a foreign fisc determines that you are overcharging a foreign associate or purchasing too cheaply from him, i.e. where your U.K. taxable profits are inflated.

As well as applying to transactions in goods the Section applies to transactions in relation to the letting and hiring of property, grants and transfers of rights, interests or licences, or the giving of any kind of business facility. It would, therefore, cover such matters as loan interest, patent royalties, management fees and service charges. Head office costs of the parent allocated to a subsidiary are regarded as within the scope as are costs allocated by any other subsidiary within the group.

As a general rule the Section does not apply unless one party to the transaction is resident outside of the U.K. for tax purposes and does not affect the operation of the provisions of the Capital Allowances Act 1968.

SALES OF ASSETS SUBJECT TO CAPITAL ALLOWANCES

S.78 and Schedule 7 of the Capital Allowances Act 1968 deal with sales of property which have been the subject of a claim to capital allowances. If the sale is between associated persons, or the sole or main benefit which might have been expected to arise, apart from these provisions, would have been the obtaining of an allowance or deduction or the reduction of a charge, then an open market price will be substituted. This price will be adjusted where the property has appreciated in value to ensure that only the capital allowances given to the seller are recaptured.

Similar provisions are to be found in the Finance Act 1971 which brought in the system of first year allowances. This system of first year allowances was phased out over a period beginning on 13 March 1984 and ending on 1 April 1986 but the provisions in respect of sales may still be relevant.

These provisions apply to sales between associated persons whether or not they are resident in the U.K. Although where there would have been no tax benefit and the buyer and seller are U.K. resident they can elect to transfer at the value appropriate to the capital expenditure which has yet to be allowed for capital allowance purposes.

CAPITAL GAINS (Capital Gains Tax Act 1979)

Capital gains tax (in the case of a company corporation tax on chargeable gains) is charged on the disposal of all forms of property whether or not situated in the U.K., including options debts and incorporeal property, currency other than sterling, and property created by the person disposing of it or otherwise

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coming to be owned without being acquired (S.19(1)). As far as companies are concerned tax is only charged on disposals of chargeable assets by them if they are resident for U.K. tax purposes.

S.62 deals with transactions between connected persons and provides that such a transaction shall be dealt with as a bargain not made at arm's length. This has the effect of bringing the transaction within S.29A which provides that the disposal and acquisition shall be deemed to be for a consideration equal to market value. Market value is defined in S.150 and is the price which the asset might reasonably have been expected to fetch on a sale in the open market.

Companies are connected if the same person has control of both, or a person controls one company and he and persons connected with him have control of the other. They are also connected if a group of two or more persons control each company, and the groups consist of the same persons, or could be regarded as consisting of the same persons by substituting for any person a person with whom he is connected. Connected persons include, inter alia, husbands, wives and relatives. Control has a different meaning to that used for S.485 ICTA 1970 purposes and is set out in S.302 ICTA 1970. It includes not only the ability to exercise control but also the ability to acquire control.

ENFORCEMENT

As I said earlier, the principal piece of legislation in the area of transfer pricing is S.485 ICTA 1970. The Section provides powers for the Board of Inland Revenue to make a direction that the provisions of the Section shall have effect. They are empowered to make any adjustments that are necessary by way of assessment or repayment of tax or otherwise. Normally directions are not made but instead agreement is reached following negotiations with the local Inspector of Taxes. Where substantial amounts of money or important matters of principle are involved, negotiations will be dealt with by a special Head Office Section dealing with inter-company pricing. Again it will normally be the case that agreement with the taxpayer is reached and no direction is made.

If necessary the U.K. Revenue has substantial powers to obtain information. Section 17 of the Finance Act 1975 relates specifically to transfer pricing matters under S.485 ICTA 1970. It enables the Board of Inland Revenue to obtain information relevant both to the taxpaying company's own transfer prices and also to the transfer pricing of other companies. These other companies need not be associated with the company being investigated. If the transaction which is the subject of investigation is between a 51% overseas subsidiary of a U.K. parent and that U.K. parent or a 51% U.K. subsidiary of that parent, the Board can ask for inspection of books, accounts, documents and records. The Section also empowers the Board to authorize an Inspector of Taxes to examine any relevant documents on the taxpayer's premises.

Without the special powers relating to S.485 ICTA 1970 the Inspector can assess the liability to tax based on his own estimate of what that liability should be. The taxpayer can then appeal to a body of independent Commissioners, in the first instance, where the onus would be upon him to disprove the assessment. An assessment can be made at any time within six years of the end of the chargeable period to which the assessment relates, and a further assessment can be made for the same period if the Inspector discovers subsequently that profits had not been assessed or that reliefs given were excessive. An appeal can be pursued beyond the independent Commissioners to the High Court, Court of Appeal and ultimately to the House of Lords, which is the highest Court of the land.

The Revenue have thus sufficient powers to give effect to the legislation on transfer pricing and the taxpayer has the opportunity to pursue his case through the legal system where he thinks any adjustment is unjustified. By the very nature of the transfer pricing problem – there is after all no legal definition of an arm's length price, nor could there be – most disputes will be settled by agreement with the Revenue. A practice note has been published on the transfer pricing of multinational enterprises by the Inland Revenue which sets out how they approach this area. This is reproduced at the end of this note.

THIN CAPITALIZATION AND INTEREST PAYMENTS

There is no general rule which applies to thin capitalizations. There are, however, statutory provisions which effectively apply this concept where interest is paid by a U.K. resident subsidiary to its non-resident parent.

S.233(2)(d)(iv) ICTA 1970 provides that payment of interest on securities issued by a resident company to a non-resident parent owning 75% or more of the ordinary share capital of the subsidiary, whether directly or indirectly, shall be treated as a distribution. The same consequence follows if the interest is paid to a non-resident fellow 75% subsidiary. Security is defined widely in S.237 ICTA 1970 and would cover interest payments generally. The effect of this legislation is to deny relief for the interest paid by the resident subsidiary and to require advance corporation tax to be accounted for in respect of the payment.

A remedy for this situation is generally found in the appropriate double taxation treaty. The non-discrimination article will usually provide that, with the important exception mentioned below, interest paid by a resident of one Contracting State to a resident of the other shall be deductible under the same conditions as would apply if the payment of interest had been made to a resident of the same Contracting State. Normal U.K. legislation under Ss.248 & 249 and S.130(m) ICTA 1970 together with S.485 ICTA 1970 would allow the deduction of a reasonable commercial rate of interest paid to a non-resident.

Where by reason of a special relationship between the payer and the recipient of the interest, the amount of the interest, having regard to the debt-claim for which it is paid, exceeds the amount which would have been

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agreed between the parties in the absence of such special relationship the interest article does not usually apply to the interest excess. In such cases the protection in the non-discrimination article will not apply to any part of the payment. The U.K. Revenue contend that such a provision requires them to consider whether a third party lender would have made a loan of that amount to the borrower as well as considering the appropriateness of the rates of interest thus bringing in matters not found in domestic legislation. The Revenue appear to have become much tighter on the question of "thin capitalization". Queries have been raised where the debt/equity ratio of the resident subsidiary was as low as 1:1.

OTHER TRANSFER PRICING ADJUSTMENTS – WHETHER THEY ARE DISTRIBUTIONS

Similar provisions in double tax agreements are generally applied to royalties, and commercial or financial arrangements where the payer and recipient are associated. In such cases an argument could be made that any transfer pricing adjustment should be treated as a distribution for U.K. tax purposes. However, I understand that the U.K. Revenue are usually satisfied with an adjustment to the arm's length price. The same would not be true where capital assets were transferred at an undervalue. In this case the Revenue could be expected to contend that the undervalue was a distribution. S.233(2)(b) and (d) ICTA 1970 treats as a distribution any distribution out of the assets of the company. The distribution must be in respect of shares in or securities of the company and there may be circumstances on the transfer of a capital asset where it could be argued that this legislation does not apply.

EXCHANGE OF INFORMATION AND MUTUAL AGREEMENT PROCEDURES

Treaties entered into by the U.K. all provide for the exchange of information on the lines of Art. 26 of the OECD Model Double Taxation Convention. This enables information to be exchanged between the relevant tax authorities to enforce the adjustment of transfer pricing. The Articles provide that information is to be used for tax purposes only and exclude the exchange of information which would disclose business secrets.

Some doubt has been expressed as to whether U.K. legislation in S.497 ICTA 1970, which enables arrangements to be made with other countries to afford relief from double taxation and prevent evasion of tax, permits the exchange of information. A provision introduced in the 1987 Finance Bill will remove this doubt (Clause 162).[1]

Art. 9(2) of the OECD Model Convention which is incorporated into treaties entered into by the U.K. provides for consultation between the contracting parties with a view to preventing the double taxation which would arise where one country made a transfer pricing adjustment and the other country did not make a corresponding adjustment. However, an agreement between the two contracting parties does not necessarily provide a solution since the U.K. Revenue can only make a corresponding adjustment if this is possible under U.K. domestic law. It is, therefore, necessary to appeal against U.K. tax assessments within the necessary time limits for making such appeals. It is not possible to re-open an assessment which has become final although if the adjustment requires a claim to relief from double taxation this can be made within six years from the time when the adjustment is made (S.512 ICTA 1970).

It should be noted that there is no guarantee that the U.K. will agree with the adjustment made by the other contracting party and until some procedure such as independent arbitration is made mandatory, the position is unsatisfactory.

PROFITS OF PERMANENT ESTABLISHMENTS

There is, strictly, no inter-company pricing problem, since all transactions are within the same enterprise. However, the U.K. follows the Business Profits Article of the OECD Model Convention which provides that there shall be attributed to the 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. The U.K. approach is therefore similar to that outlined in the rest of this paper, although the treatment of interest provides special difficulties. Where the company uses its own funds to finance its U.K. branch, there will be no tax relief for any interest payments. Even where the non-resident company borrows to finance its U.K. branch, it may have difficulty in obtaining relief for the interest paid. Interest paid on an advance from a bank carrying on a bona fide banking business in the U.K. will be allowable as a trading deduction in computing the profits of the branch's trades (S.251(3) ICTA 1970) as will short interest generally, i.e. interest on a loan for less than 365 days.

On the other hand, yearly interest, in the absence of a double taxation treaty, would never be deductible because of the requirement in S.248(4) ICTA 1970 that the payer should be a company resident in the U.K. However, it is understood that the Inland Revenue will allow relief where there is a double taxation treaty containing a Non-Discrimination Article and a U.K. resident company would have been entitled to relief in similar circumstances.

Specific legislation relating to permanent establishments is to be found in S.80 Taxes Management Act 1970 which provides for profits to be assessed on a percentage of the turnover of the permanent establishment where it appears to the Inspector that the true amount of the profits cannot be readily ascertained.

1. Incorporated in Finance Act, Sec. 70.

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APPENDIX

THE TRANSFER PRICING OF MULTINATIONAL ENTERPRISES

NOTES BY THE U.K. INLAND REVENUE[1]

1. Introduction

These notes are primarily designed for the guidance of overseas companies which have, or may be thinking of setting up, subsidiaries in the U.K.; but the law and practice described apply to U.K. resident companies generally.

2. General – the arm's length principle

Prices charged in transactions between connected companies in a multinational group (transfer prices) may be designed to meet the convenience of the group as a whole. They will not necessarily produce a figure of profit or loss which can be accepted for tax purposes. The U.K. law therefore, in common with that of many other countries, provides that these prices may be adjusted in arriving at the taxable profit or allowable loss of a U.K. taxpayer. The price to which they may be adjusted is the "arm's length price". This is the price which might have been expected if the parties to the transaction had been independent persons dealing at arm's length, i.e. dealing with each other in a normal commercial manner unaffected by any special relationship between them.

3. Circumstances in which adjustments may be made to transfer prices

The relevant law is largely contained in Section 485 of the Income and Corporation Taxes Act ("ICTA") 1970. This provides the Inland Revenue with power, for example, to adjust a transfer price to the arm's length price in transactions between a resident and a non-resident body of persons when one controls the other or both are under common control.

4. Body of persons

A "body of persons" includes a partnership as well as a company.

5. Residence of a company

The general rule is that a company is resident where the central control and management of its trade or business is carried on. The application of the rule is a question of fact.

6. Control of a company

Control of a company has to be distinguished from the control and management of its trade or business. For the purposes of Section 485 it is defined in particular to mean, as in Section 534 of ICTA 1970, the power of a person to secure that the affairs of the company are conducted in accordance with his wishes, inter alia, by holding shares or possessing voting power in relation to that company (or any other company) or by virtue of any powers conferred by the articles of association or other document regulating that or any other company.

7. Scope of U.K. transfer pricing law

Section 485 applies to sales of goods and other property lettings or hiring of property, grants and transfers of rights, interests and licences and the giving of business facilities of whatever kind. Loan interest, patent royalties, management fees, and payments for services are thus within its scope as well as payments for goods. Contributions by a subsidiary towards costs incurred by the parent company are similarly within its scope.

8. Tax returns – assessment of profits – onus of proof – rights of appeal

The U.K. system of taxing profits requires the taxpayer to make a return of his profits each year to the appropriate Inspector of Taxes. It is normal for his return to be accompanied by accounts and computations in some detail in order to substantiate the return. But the Inspector, if no return is made or if he is dissatisfied with a return which has been made, is however empowered to assess the liability to tax on the basis of his own estimate of the profits. The taxpayer has a right of appeal to independent Commissioners (and from the Commissioners, on a point of law, to the High Court and beyond) but it is for him in the first instance to disprove the correctness of the assessment in such an appeal and not for the Inspector to prove that it is correct.

9. Adjustment by agreement

If, however, the Inspector takes the view that it may be necessary to assess the profits on the basis of his own estimate he will normally seek, in any case where substantial amounts are at stake, to come to an agreement on the matter with the taxpayer either by correspondence or, very probably in a case where the adjustment of transfer prices is in point, by discussion round the table as well.

10. Requests for information

If it seems to the Inspector that it may be necessary to adjust a company's transfer prices for tax purposes he will normally, therefore, in the first place, ask the U.K. company for the information necessary to decide whether adjustments should be made and what sort of adjustments. There is no standard list of questions – each case will need to be looked at in the light of its own special features. But the Inspector will generally be interested in such matters as who owns or controls the company, what the nature of the trade is, how any group of which the company is a member is organised, what are the functions of particular companies in the group, what the results of the U.K. companies have been, how far they have come up to expectations and so on. The need for answers to more detailed questions may emerge as the discussions proceed.

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11. Powers to require information

The Inland Revenue have power in certain circumstances to require the production of information for tax purposes and, in particular under Section 17 of the Finance Act 1975, they may require a company to produce information which is relevant to the adjustment of transfer prices (not necessarily its own transfer prices) under Section 485 of ICTA 1970. Powers provided under Section 17 also include in certain circumstances the power to require the production of information (including books and accounts) from a U.K. resident company, which is relevant to transactions with a 51% subsidiary resident outside the U.K., including books and accounts of the subsidiary. This also applies where the transactions are between U.K. resident and non-resident companies both of which are 51% subsidiaries of the U.K. resident company. (The U.K. parent company may however appeal against the requirement to an independent body of Commissioners.) In addition, in certain circumstances the Board may require books and accounts and other documents or records which are relevant to a transfer pricing adjustment under Section 485 to be produced for examination by an Inspector of Taxes on the taxpayer's premises.

12. Confidentiality

Officers of the Inland Revenue are governed by very strict rules about the confidentiality of information received by them in the course of their duties. They are prohibited from disclosing such information except for tax purposes and, within that limitation, in very limited circumstances strictly defined by law.

13. Exchange of information with other countries

Disclosure is permitted (under strict safeguards) to other countries' tax authorities under agreements for the relief of double taxation and under the Directive concerning mutual assistance between tax authorities of the member States of the European Communities. (The Inland Revenue may also receive information from other countries under these instruments.)

14. Inland Revenue Organisation

The Inland Revenue maintains a network of local tax offices spread over the whole of the U.K. and normally the affairs of a taxpayer will be mainly dealt with by a local Inspector of Taxes. But transfer pricing problems involving substantial amounts of money or important matters of principle may be dealt with instead by a section of the central head office in London. (The affairs of oil companies including matters of transfer pricing are dealt with by a centralised Oil Taxation Office in London.)

15. Objectives and method of approach in adjusting transfer prices for tax purposes

The objectives of both central and local offices are however the same. The principal objective is to ensure that the U.K. taxpayer is paying the proper U.K. tax on its profits under the law. The Inland Revenue recognise, however, that answering the many detailed questions which may be necessary for the achievement of this objective may impose an onerous burden on the senior staff of companies or their advisers and they aim to keep these questions to a minimum by concentrating on the main pricing issues involved.

16. Methods of and considerations taken into account in arriving at arm's length prices

In ascertaining an arm's length price the Inland Revenue will often look for evidence of prices in similar transactions between parties who are in fact operating at arm's length. They may however find it more useful in some circumstances to start with the re-sale price of the goods or services etc. and arrive at the relevant arm's length purchase price by deducting an appropriate mark up. They may find it more convenient on the other hand to start with the cost of the goods or services and arrive at the arm's length price by adding an appropriate mark up. But they will in practice use any method which seems likely to produce a satisfactory result. They will be guided in their search for an arm's length price by the considerations set out in the O.E.C.D. Report on Multinationals and Transfer Pricing. (This Report examines the considerations which need to be taken into account in arriving at arm's length prices in general and also in particular in the context of sales of goods, the provision of intra group services, the transfer of technology and rights to use trademarks within a group and the provision of intra group loans.)

17. Settlement of problems

The Inland Revenue recognise, as does the O.E.C.D. Report, that the evidence needed to establish an arm's length price may be hard to come by and difficult to interpret and they recognise also that decisions on pricing in the arm's length situation would have had to be taken in the light of the facts which could have been known at the time when the decision was made. It is with considerations like this in mind that they are concerned to settle transfer pricing adjustments as far as possible by discussion and agreement with the companies concerned. They would hope as a result also to establish a reasonable basis of understanding with the companies for the future (possibly on the basis of a review after a number of years).

18. Consultation with other countries

The Inland Revenue recognise that transfer pricing adjustments may have a consequence not only for U.K. tax but also for foreign tax. They are able, under the terms of some seventy agreements for the relief of double taxation and the prevention of fiscal evasion, to exchange information with the tax authorities of their partner countries on transfer pricing matters among others and they often do this for the purpose of ensuring that tax is adequately charged in the U.K. On the other hand, they are also able to consult and do consult with partner countries with a view to preventing unrelievable double taxation arising from (among other causes) the adjustment of transfer prices. A taxpayer who fears that unrelievable double taxation may result in his own case from some action of the tax authorities of a treaty partner may ask the U.K. Inland Revenue to enter into such consultations and they will do so whenever the need arises. All that such a taxpayer need do is to write a letter putting his request, and giving the relevant details, to the International Tax Policy Division of the Inland Revenue in Somerset House, London. For such consultation to be effective however it will usually be necessary for the request to be made in good time so as not to be frustrated by the expiry of legal time limits for tax adjustments either in the U.K. or in the other country.

[continued on p. 516]

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SRI LANKA:

Recent Changes in the Tax Law

By R.G.L. de Silva

The Inland Revenue Act No. 28 of 1979 is the principal law which imposes income, wealth and gift taxation in Sri Lanka. This Act replaced the Inland Revenue Act No. 4 of 1963. The 1979 Act has been amended several times in the recent past and these amendments have introduced significant changes in the tax system of the country. This article attempts to give an overview of these changes, in particular the changes introduced consequent to the Budget proposals made for 1987 by the Minister of Finance and Planning.

I. CAPITAL GAINS

Change of ownership of property

Income taxation on capital gains was first introduced in Sri Lanka in 1959/60 with the implementation of tax reforms recommended by Professor Nicholas Kaldor. The recent amendment to the law provides for the complete exemption from income tax of capital gains arising on the sale of any property on or after 12 November 1986 by a person who has owned such property for over 25 years from the date of acquisition by him. This exemption seeks to exclude from taxation the capital gains that may accrue due to inflation over the years.

The profit arising from the sale of property within two years of its acquisition is now treated as normal income and not as capital gains and consequently such income is fully liable to tax at the rates applicable to the taxpayer.

The maximum rates of tax on capital gains effective from 12 November 1986 are as follows:

Period between acquisition and sale of property	*Maximum rate of tax*
2 to 5 years	25%
5 to 15 years	17.5%
15 to 20 years	12.5%
20 to 25 years	5%
Over 25 years	0

Mr. R.G.L. de Silva is a Bachelor of Laws and an Attorney-at-law of the Supreme Court of Sri Lanka. He is currently a Legal Practitioner and an International Tax Counsel after having been a Senior Official in Sri Lanka's Inland Revenue Service. Presently, he is the Honorary Secretary of the International Fiscal Association (Sri Lanka Branch).

The base date for computation of capital gains has been changed from 1 April 1957 to 1 April 1977.

Transfer of capital assets on conversion of an unincorporated business into a company

Capital gains arising on or after 1 April 1987 from the conversion of a business run as a sole proprietorship or as a partnership into a limited liability company are exempt from income tax provided that 80% of the shares of the new limited liability company is held by the former proprietor or partners. Earlier the exemption from tax on capital gains arising on conversion of a business run as a sole proprietorship or partnership into a limited liability company was available only if such a company was a quoted public company.

Sale of shares in quoted public companies

Capital gains arising from sale of shares in a quoted public company which were exempt from tax earlier have been made liable to tax as from 12 November 1986.

II. DEPRECIATION ALLOWANCES

Depreciation on all plant machinery and fixtures used in a business is allowed at 33⅓% per annum with effect from 1 April 1987. Vehicles and office equipment can be depreciated at 25% per annum. In the case of industrial or commercial buildings the rate of depreciation is 10% per annum.

Further when a capital asset is disposed of and replaced within a year by a new capital asset by using the full proceeds of the disposal, the gain arising from the disposal (which often happens due to inflation) will not be added as income as was done earlier. The depreciation allowance in respect of the new capital asset will be granted on the difference between the cost of the new asset and the proceeds of disposal of the old asset (i.e. net cost of the new asset).

III. INCENTIVES FOR EXPORTS

Under the earlier law only the persons who finally exported goods and commodities (other than traditional exports, such as tea, rubber, coconut, etc.) were

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entitled to a 5-year tax holiday. In terms of the amended provisions this tax holiday has been extended with effect from 1 April 1987 to persons who manufacture and supply goods and commodities to exporters for export if such supplies are covered by domestic letters of credit issued by a bank on a back-to-back basis against an international letter of credit for the remittance to Sri Lanka of the foreign exchange value of the exports.

Under the earlier law the 5-year tax holiday enjoyed by a company engaged in exports commenced from the year in which the company made its first export. The new law provides for the commencement of the tax holiday from the year in which the company first makes a profit from exports and not from the year in which the company makes the first export.

Half-tax holiday on export profits

Previously a company which enjoyed the tax exemption of export profits was entitled to a reduction of 50% of the income tax payable on export profits for a further period of 10 years commencing from the date of expiration of the tax exemption provided the net foreign exchange earnings from exports each year would not be less than 75% of the f.o.b. value of such exports. Under the new law the 10-year half-tax holiday period mentioned above has been reduced to 5 years. Further the threshold of 75% for foreign exchange earnings during a year has also been reduced to 50%.

IV. EXEMPTION OF THE NRFC INTEREST

The present 10-year exemption from income tax on interest from deposits in non-resident foreign currency accounts (NRFC accounts) in banks in Sri Lanka has been extended for all time without a time limit. Deposits in NRFC accounts are also exempt from wealth tax.

V. TAX EXEMPTIONS UNDER OTHER LAWS

Apart from the tax exemptions and tax holidays granted under the Inland Revenue Act, the Greater Colombo Economic Commission Law, No. 4 of 1978 also provides for granting of the exemptions and tax holidays to certain enterprises which have entered into agreements with the Greater Colombo Economic Commission established under the said Law No. 4 of 1979.

VI. "QUALIFYING PAYMENTS"

Medical expenses for indoor treatment in a hospital or a clinic incurred by an individual in any year commencing from 1 April 1987 have been included in the category of "qualifying payments" which are deductible in arriving at taxable income.

VII. HUSBAND AND WIFE

Since 1979 incomes of husband and wife are not aggregated and husband and wife are treated as two separate individuals for tax purposes. However, the income of a child (under 18 years of age) of a resident individual is aggregated with the income of his father. Where the marriage of his parents fails, the income of the child is aggregated with the income of the parent who maintains him.

VIII. RATES OF INCOME TAX FOR INDIVIDUALS

Resident individuals and non-resident individuals are taxed at the same progressive rates. A resident individual is, however, entitled to a tax-free allowance of 27,000 Rs. for a year of assessment. From 1 April 1986 the tax bands have been reduced from 11 to 5 and the maximum rate reduced from 55% to 50%. The current progressive rates of tax applicable to an individual are as follows:

On the first 21,000 Rs. of the taxable income	10%
On the next 24,000 Rs. of the taxable income	20%
On the next 24,000 Rs. of the taxable income	30%
On the next 24,000 Rs. of the taxable income	40%
On the balance of taxable income	50%

IX. COMPANY TAX RATES

Rates at which companies are taxed are as follows:

Resident company

On the taxable income of a quoted public company	40%
On the taxable income of a private limited liability company	50%
On dividends distributed by a resident company	20%

Non-resident company

On the taxable income	50%

A non-resident company is also liable to tax on remittances of profits abroad at 33⅓% of remittances or 11⅑% of its taxable income, whichever is lower.

A non-resident company is not liable to tax on dividends distributed as in the case of a resident company.

X. WITHHOLDING TAX ON INTEREST

As from 1 April 1986 every bank and financial institution is required to deduct from the interest payable by it a withholding tax of 20% of the interest. For the purposes of the withholding tax the definition of "interest" has been extended from 1 April 1987 to cover amounts paid as discounts in respect of bonds (other than Government securities) issued by a bank or a financial institution. (See *Bulletin for International Fiscal Documentation,* Volume 7 (1986), at 310, for a detailed article on withholding tax.)

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XI. DEDUCTIONS OF INCOME TAX FROM INTEREST, ETC., PAYABLE TO PERSONS OUTSIDE SRI LANKA

Section 81 of the Inland Revenue Act, No. 28 of 1979 requires that any person in Sri Lanka who pays or credits to any person or partnership outside Sri Lanka any sum as interest, rent, ground rent, royalty or annuity in respect of property in Sri Lanka or income arising in Sri Lanka shall deduct income tax at 33⅓% from the sum so payable, notwithstanding any agreement to the contrary. The new law provides for deduction of tax at 33⅓% or the lower rate (generally 10%) specified in respect of such income in double taxation treaties entered into by Sri Lanka.

XII. EXPATRIATE EMPLOYEES

Liability to income tax under Sri Lankan law is based on residence and not on citizenship. A resident person is liable to tax on income wherever arising (global income) and a non-resident person is liable to tax only on income arising in or derived from Sri Lanka. An individual is considered "resident" or "non-resident" on the basis of his presence in or absence from Sri Lanka. A foreign citizen who arrives in Sri Lanka and resides in Sri Lanka for a period (or periods in the aggregate) exceeding six months during the year commencing from the date of his arrival will be deemed to be a "resident" in Sri Lanka throughout that year if he is in Sri Lanka at the end of that year. If not, he will be deemed "resident" up to the date of his last departure in that year. However, in terms of Section 67(7) of the Inland Revenue Act, where a foreign citizen is employed in Sri Lanka, he is deemed to be a non-resident for tax purposes for three years calculated from the date on which he commences employment in Sri Lanka and consequently liable to income tax only on income arising in Sri Lanka during the said period of three years. Further, he will not be subject to tax at progressive rates, but will be taxed at a flat rate of 25%.

XIII. APPEALS

Under the new law any appeal made after 1 April 1987 to the Commissioner General of Inland Revenue against an assessment shall be agreed to or determined within two years from the date of receipt of the appeal, unless the agreement or the determination of the appeal depends on furnishing of documents or taking of any action by a person other than the appellant or the Inland Revenue. Where such appeal is not so agreed to or determined the appeal is deemed to have been allowed and tax charged accordingly. This provision, however, will not apply to appeals made to the Board of Review or to the Court of Appeal.

The amendment to the law also provides for the appointment of a panel of adjudicators to hear appeals lodged with the Commissioner General of Inland Revenue. Any such adjudicator when authorized by the Commissioner General will exercise the powers of the Commissioner General in regard to the hearing of an appeal as may be specified in such authorization.

XIV. PENALTY FOR FAILURE TO FURNISH RETURN

The Commissioner General of Inland Revenue is empowered to impose as penalty a sum not exceeding 5,000 Rs. for failure to furnish returns on income, wealth and gifts. This limit has now been increased to 50,000 Rs.

XV. ESTATE DUTY AND GIFT TAX

Estate duty on the estate of a person dying after 13 November 1985 and gift tax on gifts made after 13 November 1985 have been abolished.

[continued from p. 513]

19. Time limits for claims for credit

So far as concerns claiming relief for foreign tax against U.K. tax the normal rule is that a claim in respect of any income, must be made not later than six years from the end of the chargeable period for which the income is chargeable to U.K. tax. However where such credit has been rendered insufficient by reason of an adjustment to the other country's tax the time limit for a claim to additional credit is six years from the time when the adjustment was made – Section 512 ICTA 1970.

20. Status of these notes

These notes are for guidance only. They express the Inland Revenue's view of the law but they have no legal force and they do not affect any rights of appeal on points concerning a taxpayer's liability. Similarly any description in these notes of Inland Revenue approaches to the problem of transfer pricing or practices in dealing with this problem are not to be taken as limiting the Department to such approaches or practices in any particular case.

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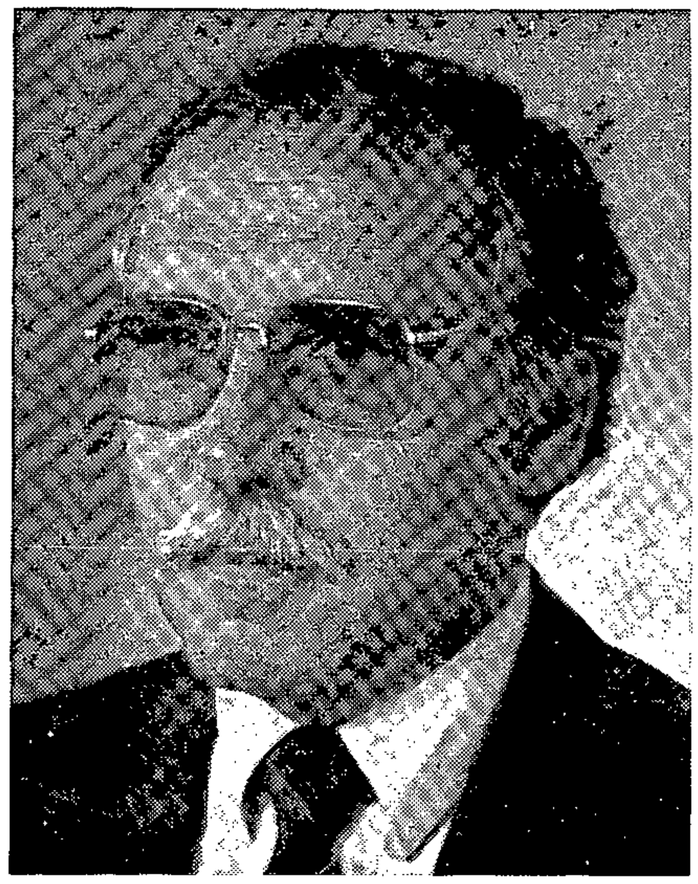
INTERNATIONAL FISCAL ASSOCIATION NEWS

Some Highlights from the Secretary General's 1986 Annual Report

Presented at the Brussels Congress 1987



Prof. Dr. J.H. Christiaanse

IN GENERAL

The Secretary General, Prof. Dr. Jan H. Christiaanse, paid homage to the outgoing General Treasurer, Mr. P. den Boer, whose judicial administration of IFA's funds has made that association a financially healthy organization. Prof. Christiaanse welcomed Mr. J. Westerburgen as IFA's new General Treasurer. Mr. Westerburgen has a distinguished background as a former official of the Dutch tax department who has in particular been very active within the OECD.

The results of the questionnaire sent to IFA members in 1985 have been analyzed by a research bureau of the Erasmus University of Rotterdam. Generally IFA members are satisfied with the scientific and social features of the congresses, although new members sometimes found the programmes less attractive. The congress costs were generally considered to be high, also in comparison to other congresses. A reduction in the amount of simultaneous translations would not meet with too many objections. Some doubts existed as to whether the inquiry was truly representative. A fair part of the regular congress participants gave their opinion, but Asia and the Spanish speaking countries were not as well represented as was hoped for. The results of the inquiry have been submitted to the Permanent Scientific Committee and to a committee selected from members of the Executive Committee who have previously organized congresses. They will draw conclusions for possible improvement of the situation.

Following the New York Congress the U.S. Branch of IFA made a generous donation to the treasury of Central IFA of $ 16,000.

NEW YORK CONGRESS 1986

The 40th IFA Congress was held in New York at the Marriott Marquis Hotel. It was again a very large Congress attended by 2,200 persons. IFA is indebted to the President of the Congress, Mr. Sandy Goldberg, and the ladies of the Organizing Committee, in particular Mrs. Arlene Roberts and Mrs. Shirley Munyan, who organized a smoothly run congress. As was the case with the London Congress, the Opening Ceremony took place on Sunday evening. For this purpose the United Nations had offered the Hall of the General Assembly where Mr. James A. Baker III, Secretary of the U.S. Treasury, and Mr. Olin, Under Secretary of the United Nations, were present.

Because of illness the Secretary General was not able to attend the Congress. His function was taken over by Mr. R. Lenz (Switzerland).

Mr. R.A. Schroder (U.S.A.) chaired the working session on Subject I: *The transfer of assets into and out of a taxing jurisdiction,* Prof. Dr. A.J. Rädler (Germany) acted as Discussion Leader, Mr. Y. Kergall (France) was the General Reporter and Mrs. B. Zak (U.S.A.) the Secretary. Panelists were Messrs. D. Rosenbloom (U.S.A.), G. Coulombe (Canada), R. von Siebenthal (Switzerland), M. Pires (Portugal) and G. Sass (EEC).

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Mr. F.J. Walsh (U.S.A.) chaired the working session on Subject II: *Currency fluctuations and international double taxation,* Mr. J.W.B. Westerburgen (Netherlands) was the Discussion Leader and Mrs. M. Burge (U.S.A.) and Mr. P. Farber (U.S.A.) the co-General Reporters and Mr. S. Nauheim (U.S.A.) the Secretary. Panelists were Mrs. Jill Pagan (U.K.), Dr. S. Doria (Brazil), Mr. S. Kobayashi (Japan) and Mr. D.C. Orrock (Australia).

Seminar A on *Taxation of domestic shareholders on undistributed income of foreign corporate affiliates; objectives, techniques and consequences* was chaired by Prof. B.J. Arnold (Canada). Panelists were Messrs H. Becker (Germany), M. Cayley (U.K.), D. Hund (Netherlands), R.C. Pugh (U.S.A.) and D. Lemaire (France).

Seminar B on *International tax treatment of common law trusts* was chaired by Prof. H.P. Dale (U.S.A.). The Secretary was Mr. J. de Carlo, Jr. (U.S.A.). Panelists were: Messrs. P. Gillioz (Switzerland), J. Killius (Germany), F. Tripet (France), D.T. Trautman (U.S.A.) and J.C. King (Australia).

Seminar C on *Issues in state and local taxation in the United States* was chaired by Mr. P.T. Kaplan (U.S.A.). Panelists were Messrs. G. Carlson (U.S.A.), R.W.G. Chu (U.S.A.), J. Lees (Canada) and R. Leegstra (U.S.A.).

Seminar D was on *Taxation of income from investments in the United States real property by foreign persons after the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA) and 1984 withholding amendments.* The English group was chaired by Mr. M. Langer (U.S.A.) with Messrs. M. Abrutyn (U.S.A.), C. Estes (U.S.A.) and A. Fogarasi (U.S.A.) as panelists. The seminar in the French language was conducted by Mr. L. Silverstein (U.S.A.) and Ms. C. Halphen (U.S.A.). The German speaking group was addressed by Messrs. L. Levin (U.S.A.), H. Conston (U.S.A.) and R.H. Sharpenberg (U.S.A.).

PERMANENT SCIENTIFIC COMMITTEE

The PSC met in Brussels at the invitation of the Belgian-Luxembourg Branch. Two new members have been appointed, i.e. Mr. O.P. Vaish (India) and Mr. D. Tillinghast (U.S.A.). The PSC reviewed the proceedings of the New York Congress. Key factors for its success were the thorough preparation of the Panels and the briefing of the panelists, the close coordination between the organizing Branch and seminar panelists, and the close coordination between the organizing Branch and Central IFA regarding the scientific information to be prepared and to be distributed to the participants. Some participants believe that panelists sometimes took up too much time by repeating what had been published in the Cahiers. The PSC will try to improve this situation by briefing the persons involved. The procedure for the adoption of Resolutions implemented after the London Congress has been found to work well.

The PSC has been discussing (in coordination with the Executive Committee) the institution of regional congresses. Leading IFA members in India and the Far East feel removed from the regular IFA Congresses, not only because of the distance, but also in that the subjects which are discussed are not always relevant to their domestic problems. Regional congresses may, therefore, solve this problem.

EXECUTIVE COMMITTEE

The Executive Committee met in May 1987 in Brussels also at the invitation of the Belgian-Luxembourg Branch. Mr. C.A. Poissant, First Vice President, had to retire because of statutory requirements. Two new members were elected: Mr. D.C. Orrock (Australia) and Mr. D.A. Ward (Canada). It was announced that in honour of the 50th anniversary of IFA in 1988 two special books will be issued to the membership to commemorate this occasion, i.e. a jubilee book describing the first fifty years of IFA and (in cooperation with the International Bureau of Fiscal Documentation) a book containing all of IFA's Resolutions adopted in previous years together with a glossary in four languages of the tax language used in the Resolutions. The Executive Committee reviewed these publications and checked their progress.

Membership fees

As a direct result of the decline of the U.S. dollar a slight increase was proposed. If this proposal is approved the 1988 membership fees will be:

US$ 40 for individual members of national IFA branches;
US$ 45 for direct individual members of IFA;
US$ 100 for corporate members, both direct and of national branches.

National branches and membership

During the New York Congress no new national branches were recognized but it was hoped that in 1987 a Pakistan Branch would be established. Mr. A. Elvinger (Luxembourg) once again chaired the Nominations Committee, assisted by Mr. D.F.A. Davidson (U.K.), Mr. T. Miyatake (Japan) and Mr. J. Sainz Alarcon (Mexico). A number of branches have been very active throughout the year by holding meetings (including bilateral international meetings), tax workshops and seminars. To the extent news has been received by Central IFA of these meetings, the information has been passed on to the *International Bureau of Fiscal Documentation* for inclusion in the IFA News Column in the *Bulletin for International Fiscal Documentation.* The Secretary General renewed his appeal to all persons involved in such meetings, to send their branch news to Central IFA. In this manner member branches will be informed of each other activities through the *Bulletin.*

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The ties with the IBFD continue to be strong. Mr. H.M.A.L. Hamaekers, the IBFD's Chief Executive, succeeded Prof. J. van Hoorn Jr. in 1985 and has held this position for more than a year. During the General Assembly of the New York Congress in 1986 IFA recognized Prof. Van Hoorn's commitment towards the work of IFA and the IBFD by presenting him with a silver medal and conferring upon him the Honorary Membership of IFA.

The Secretary General was nominated as Member of the IBFD's Board of Trustees and attended its Annual Meeting in May 1987.

BRUSSELS CONGRESS 1987

At the time this report was written, the preparations for the Brussels Congress were finalized. The Opening Ceremony will be held on Sunday evening 6 September 1987 at the Heyzel Congress Venue. It is expected that Prince Albert of Belgium will attend.

The officers for the 1987 Brussels Congress will be: General Reporter for Subject I *(The fiscal residence of companies)* Prof. Dr. J.M. Rivier (Switzerland); and for Subject II *(Tax problems of liquidations of companies)* Prof. Dr. G. van Frayenhoven (Belgium). Chairmen of Seminars A *(Taxation and Human Rights)*, B *(Effectiveness of current competent authority procedures for relief of international double taxation)*, and C *(Belgium and Luxembourg – future developments)* will be Messrs. M. Baltus (Belgium), L. Hinnekens (Belgium) and A. Elvinger (Luxembourg), respectively.

Discussion Leaders will be Prof. H. Ault (U.S.A.) for Subject I and Prof. N. Mattsson (Sweden) for Subject II. Chairmen of the Resolutions Committees will be Prof. Avv. P. Adonnino for Subject I and Mr. A. Gauthier (Canada) for Subject II. The various panels will be assisted by distinguished IFA members.

FUTURE CONGRESSES

Amsterdam Congress 1988 (50th Anniversary of IFA)

The subjects for the Amsterdam Congress were determined as follows:

Subject I: *Recognition of foreign enterprises as taxable entities.* General Reporter: Prof. Dr. C. van Raad (Netherlands).

Subject II: *Tax treatment of computer software.* General Reporters: Messrs. J. Jones and R. Mattson (U.S.A.).

Seminar A: *Data processing in taxation.* Chairman: Dr. H. Sebiger (Germany).

Rio de Janeiro Congress 1989

The subjects for this Congress will be:

Subject I: *The disregard of the legal entity.* General Reporter: Dr. Condorcet Pereira de Rezende (Brazil).

Subject II: *Administrative and compliance costs.* General Reporter: Prof. C. Sandford (U.K.).

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 law having an important relation with fiscal law in foreign countries, was awarded in 1987 to Dr. Bertram Fischer (Germany) for his work: *Die Gewinnermittlung für die Körperschaftsteuer der US-Einzelstaaten nach dem Konzept der unitary business taxation* (Determination of profits for corporate tax in the individual states of the U.S.A., using the concept of unitary business taxation). The Jury decided to award "Honourable Mentions" to Mr. Bernd Siefert for his book: *Die Besteuerung bei der Entsendung von Arbeitskraften in das Ausland* (Taxation when employees are sent to work abroad) and to Mr. Dieter Endres for his book: *Die Besteuerung von Direktinvestitionen in Entwickelungsländern* (Taxation of direct investment in developing countries).

Resolutions XLI IFA Congress, Brussels 1987

SUBJECT I: The Fiscal Residence of Companies

Resolution (original version)

The XLI IFA Congress:

RECALLING its Resolution of the XLth Congress, New York, 1986 of Subject I, Transfer of assets into and out of a taxing jurisdiction,

TAKING NOTE of the twenty-nine National Reports and the General Report as published in Cahiers Volume LXXIIa, and

TAKING FURTHER NOTE of the discussions held during the Congress on September 7th, 1987, in which it was generally recognised that:

1. the continuous expansion of international business, makes it increasingly important to determine the fiscal residence of companies so as not to create obstacles to such international expansion;

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2. there is a need for clear and well-defined rules with respect to this complex and difficult issue;

3. there are two different basic approaches to the determination of fiscal residence of companies:
(a) there is the so-called formal approach which, for example, considers the place of incorporation or the statutory seat,
(b) there is the so-called substantive approach, which, for example, considers central management and control, day-to-day management, main business activity, or residence of the controlling shareholders;

4. there is also diversity in the manner in which the constituent aspects and rules of these approaches are interpreted or applied;

5. furthermore, the significance of fiscal residence varies according to whether a country taxes a resident company on a world-wide basis or on the territoriality basis, being less important in the latter case;

6. the conflict arising from the above-mentioned differences can result in inadvertent multiple residence of companies or deliberate multiple residence of companies;

7. there are circumstances where the transfer of fiscal residence or the migration of companies (where this entails the transfer of fiscal residence) may lead to incidences of premature or double taxation, for the company or its shareholders;

8. the matter of residence is further complicated by the departure from domestic notions of residence in certain double taxation agreements;

9. the basic issues of residence may also be complicated when countries in dealing with treaty shopping (which may entail abusive or undue utilisation of double taxation agreements between two countries by persons of third countries) seek to limit, in their domestic legislation or bilateral double taxation agreements, the applicability of treaty benefits by:
(a) modifying the definition of residence for treaty purposes, or
(b) prescribing restrictive rules concerning the circumstances in which a resident of one of the Contracting States may claim the benefits of the relieving provisions of a double taxation agreement, in respect of taxation imposed by the other Contracting State;

CONSIDERING THAT:

1. during the discussions different preferences were expressed with respect to the basic approaches;

2. such lack of consensus resulted from:
(a) differing backgrounds, historical developments and experience of the various countries, and
(b) the fact that each approach has advantages and disadvantages;

3. the theoretical merits of the substantive approach were stressed by some speakers whereas the practicalities of the formal approach were underlined by others;

4. in the present state of corporate and tax legislation it appears difficult to expect that countries should depart from their national definition of corporate residence, but nevertheless international double taxation resulting from the application of such national definitions should be avoided;

RECOMMENDS THAT:

1. double taxation agreements eliminate (i) instances of double taxation and (ii) ineligibility for treaty benefits resulting from the application of domestic definitions of residence by providing a hierarchy of tests resolving cases of dual residence and by applying mutual agreement procedures to issues remaining unresolved thereunder;

2. limitations of treaty benefits in cases of treaty shopping should be restricted to cases of abuse fully and clearly identified in the double taxation agreement.

SUBJECT II:
The Problems of the Liquidation of Corporations

Resolution (original version)

The XLI IFA Congress:

TAKING NOTE of twenty-six National Reports and the General Report as published in *Cahiers de droit fiscal international* – Volume LXXIIb, deuxième sujet, and

TAKING FURTHER NOTE of the discussions held during the Congress on 8th September 1987, where the subject was analysed by considering the following questions:

1. Are there any reasons to tax the income of a corporation differently during the period of liquidation?

2. Should distributions to shareholders, in excess of the capital invested, be treated as capital gains, dividends or a combination of both?

3. How should losses, incurred either by the corporation or by the shareholders, be treated?

4. Could international double taxation result from liquidation and, if affirmative, how could such double taxation be eliminated?

I. CONSIDERING THAT:

1. the general consensus of the assembly was that the usual rules of taxation should continue to apply during the period of liquidation recognizing, however, that particular features of domestic tax systems and the need to revalue the assets of the corporations may require special rules;

2. it is desirable that the taxation rules be neutral, in that they should not be a factor in deciding whether or not to liquidate;

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RECOMMENDS THAT:

the usual rules of taxation continue to apply during the period of liquidation with as few exceptions as possible.

II. CONSIDERING THAT:

1. certain States tax distributions without allowing the deduction of losses incurred by shareholders;

2. the general consensus of the assembly was that gains should not be taxed without corresponding relief for losses of a similar nature;

RECOMMENDS THAT:

losses incurred by shareholders as a result of the liquidation of a corporation, including losses arising from liabilities assumed by shareholders, should qualify for corresponding tax relief provided that distributions are taxable without discrimination for individual shareholders.

III. CONSIDERING THAT:

1. the unanimous view was that the capital invested by shareholders should be recovered free of tax;

2. the general consensus was that such capital be adjusted to take inflation into account;

RECOMMENDS THAT:

the capital invested by the shareholders, adjusted to take inflation into account, be recovered free of any taxation.

IV. CONSIDERING:

1. that the States that tax the distributions to shareholders in excess of the capital invested treat them as capital gains, dividends or a combination of both;

2. the diversity of opinions expressed by the assembly;

3. that such different treatment may result in international double taxation;

4. the importance of this matter having regard to the increasing free movement of capital;

5. the desirability to eliminate double taxation;

6. the general consideration given to model conventions;

RECOMMENDS THAT:

1. States specifically consider and solve the double taxation that could result from corporate liquidations, when negotiating tax conventions;

2. international organisations drafting model conventions study the provisions that could be inserted in such model conventions to prevent double taxation.

FRENCH BRANCH

Board meeting

On 18 June 1987 the Board of the French Branch of IFA met under the Presidency of Mr. Delorme. Points of discussion were the acceptance of candidates for membership and the Annual Congress to be held in September in Brussels, where Mr. Baconnier, Director General of Taxes, would participate in the seminar on the Human Rights Convention. As a response to the proposed increase of the membership fees (as a result of the drop in the value of the U.S. dollar) some board members suggested to quote the membership fees henceforth in Dutch florins since most expenses are incurred in that currency. Speaking for the French Branch of IFA the President proposed to hold in 1994 or 1995 an IFA Congress in Cannes. This suggestion met with the approval of the persons present.

Branch meeting

On 11 June 1987 a Branch meeting was held which was attended by about 100 members. The reports for the 1988 Amsterdam Congress of IFA submitted by Messrs. Andrieux and Le Gall on the recognition of foreign enterprises as taxable entities and by Mr. Yan de Kergos on the tax treatment of computer software were very much appreciated.

Preparations are being made for a seminar on 2 December 1987 on hedging operations on the financial market. There will be a panel to be chaired by Mr. Gérard de la Martinière, Finance Inspector and President of the *Chambre de Compensations des Instruments Financiers* in Paris. Members of the panel will be: Messrs. Jean Lemièrre, Finance Inspector and Director of the *Service de Législation Fiscale;* Xavier de Sarrau, Legal and Tax Counsellor; Michel Taly, Secretary General of the *Banque Lazard Instruments Financiers;* and Pascal Coudin. No seminars will be held outside Paris in 1977 but the President of the French Branch is discussing the possibility of organizing a local seminar in either Toulouse or Montpellier in 1988.

The next meeting has been set for 27 October 1987 at the ANSA building in Paris (18.00 hrs.).

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XIIIth Symposium of the Latin American Tax Law Institute*

The XIIIth Symposium of the Latin American Tax Law Institute was successfully conducted on 14-17 September 1987 in Palma de Mallorca, Spain. The International Bureau of Fiscal Documentation was represented at the Symposium by Mr. Miguel García Caballero who has translated the resolutions. The English translation of the resolutions printed in this issue is an unofficial translation. The official text is in Spanish.

SUBJECT I (JURIDICAL)
Allocation of tax related competence between different governmental levels

The XIIIth Symposium:

IN CONSIDERATION OF:

the national reports submitted by E. Bullit (Argentina), D. de Campo (Brazil); L. Cruz (Colombia); E. Gonzalez (Spain); F. Rodriques (Portugal); and A. Mazz (Uruguay);

the general report of J. Ramallo, and the remarks made during the working sessions;

CONSIDERING THAT:

in substance the recommendations adopted in the first symposium on Subject III held at Montevideo and the third symposium on Subject IV of Sao Paulo are ratified;

there are three fundamental competences which exist in the public revenue sector: namely, the competence to issue provisions, the competence to administer those provisions, and the competence to dispose of or utilize the revenues; and all these may be performed either fully by a single entity or shared by several entities;

the principal of legality, which is at the core of tax law, cannot disregard its origin in the principal of consent by the citizens to be subject to the burdens of society and, consequently, laws produced by representative assemblies which are constitutionally recognized cannot be denied legitimacy as sources of positive law in their respective branches;

RECOMMENDS THAT:

the distribution of tax competences between different levels or spheres of jurisdiction in a country correspond to the constitutional power to issue provisions, with the possibility of being implemented by ordinary legislation where constitutionally provided;

such a distribution should be adjusted to each one of those levels or spheres of jurisdiction in order to insure an efficient and balanced functioning of the state as a whole, not only so as to adequately satisfy the needs of the public, but also to establish a fair contribution by the affected persons;

the superposition of the same or even different levels or spheres of jurisdiction on identical facts or transactions should be rejected in as much as they are contrary to the principal of the capacity to pay tax and the plenary development of economic activities;

the different levels or spheres of jurisdiction should coordinate the exercise of their respective tax related competences in a horizontal and vertical manner in order to rationalize at the maximum the exercise of such competences, protect the sources of taxation and not exceed a reasonable level of total tax burden;

the distribution of tax related competences should not obstruct the realization of a national economic and social policy.

SUBJECT II (ECONOMICS):
Distribution of public expenditures between the different governmental levels

The XIIIth Symposium:

IN CONSIDERATION OF:

the national reports of Argentina, Brazil, Ecuador, Spain and Uruguay and the technical communications submitted on the subject;

the discussions and the debates of the delegates present;

CONSIDERING THAT:

the supply of public goods and services by local authorities permits, in principle, greater access to the taxpayer, and better understanding of the taxpayer, and a better adaptation of public expenditures to the peculiarities of each collective in consideration of the pertinent political mechanisms;

when the public goods or services concerned are clearly indivisible and effect the nation as a whole or have important external effects in relation to the various regions, the competence is preferably centralized;

the greater the degree of autonomy and decentralization the greater the risk of consolidation and increase in differences in production, income, and wealth be-

* The Latin American Institute of Tax Law (ILADT) is a Spanish-Portuguese speaking regional tax organization. Member countries are the Spanish and Portuguese speaking countries in Latin America and Spain and Portugal; each of these countries has its own Institute/Association of Tax/Finance Law studies which are branches agglutinating national tax experts of recognized prestige. The ILADT holds its Jornadas (symposiums) once every two years in September immediately before or after the annual IFA Congress and, where feasible, not far from the place where the IFA Congress takes place. The Resolutions adopted in ILADT's Jornadas are often taken into consideration by the authorities of most Latin American countries.

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tween the different regions of the country which, consequently, requires compensatory mechanisms;

the fact that a local authority may assume the responsibility for the expenditure, but not the unpopular responsibility to finance the expenditure, does not stimulate the exploration of its own taxable basis and excludes the need to evaluate costs and benefits essential in any economic decision;

the existence of theoretical difficulties to specify the service corresponding to each level impedes a strict allocation between the levels;

RECOMMENDS THAT:

1. the allocation of responsibilities in the supply of public goods and services between the different levels of government should be as flexible as possible, taking into consideration the nature of such goods and services;

2. any competence in respect to expenditures should be accompanied by a sufficient parallel power to collect taxes, reducing intergovernmental transfers;

3. notwithstanding, reallocation measures should be established to help the regions attain levels of public welfare and services comparable to the other regions of the country.

HONG KONG:

The So Chak Kwong Case

By I.W. Harris

At first glance the Hong Kong Inland Revenue Ordinance may appear to be very simple because even after some 40 years of operation and in what is now a very major trading and financial centre the legislation still does not extend beyond 150 pages in the official version. However, perhaps because of its simplicity coupled with both the sophistication of the Hong Kong economy and the productivity of the Inland Revenue Ordinance (collection costs were only 1.54% in 1985/86) it is perhaps not surprising that a number of disputes do occur between the taxpayer and the fisc.

One such instance of a dispute which may be of interest to international businessmen and which indeed may have repercussions elsewhere was decided recently by the Hong Kong High Court. The international interest arises because Hong Kong's own legislation is based on the model Colonial Ordinance which also provides the basis of legislation found in many other countries throughout the world. The particular piece of legislation which is the subject of this article is the general charging section for salaries tax contained in Section 8 of the Inland Revenue Ordinance and which states that salaries tax is charged on every person in respect of his income arising in or derived from Hong Kong from any office or employment of profit. For this purpose income arising or derived from Hong Kong from any employment includes all income derived from services rendered in Hong Kong and in determining whether or not all the services are rendered outside of Hong Kong no account is taken of services rendered in Hong Kong during visits not exceeding a total of 60 days in an assessment year. It was the question what is meant by visits which exercised the High Court of Hong Kong in the case of *Commissioner of Inland Revenue vs So Chak Kwong, Jack* which was heard before Mr. Justice Mortimer on 15 October 1986.

The appeal had arisen from a decision of the Board of Review which had found in favour of the taxpayer's contention that although his visits to Hong Kong exceeded 60 days he spent less than 60 days in Hong Kong on business during the relevant year of assessment, the balance being spent on holiday in Hong Kong.

The facts in the case were briefly that Mr. So was employed by a Hong Kong company and was seconded to a subsidiary overseas to explore and develop markets in Europe, the Middle East and North America. Although he was provided with accommodation by his overseas employer his family remained in Hong Kong for not only was his wife employed in Hong Kong, but his children were at school in Hong Kong. Mr. So was required to visit Hong Kong from time to time for business consultations with the Chairman of the Hong Kong company who was also the Chairman of the overseas subsidiary. The Hong Kong parent provided the majority of the support services for the overseas company and indeed Mr. So's remuneration was borne by the parent. The overseas subsidiary bore the costs of Mr. So's accommodation and related costs which by agreement with the overseas Revenue authority were reimbursed on a cost plus basis.

Mr. So returned to Hong Kong during the year in

I.W. Harris was born in England and educated there, but moved to Southern Rhodesia with his parents and started his career in the Tax Department of the Government of the Federation of Rhodesia and Nyasaland. When the Federation broke up in 1963 he then moved to Malawi as Chief Assessor, and was largely responsible for setting up a PAYE system there. In 1966 he moved to the Hong Kong Inland Revenue Department serving in various areas including having responsibility for the implementation of what has since become a sophisticated computer system. In 1976, after 21 years Government service, he moved to the Hong Kong Bank as Assistant Group Tax Adviser taking over as Group Tax Adviser in 1979, which position involves all aspects of the Hong Kong Bank Group's taxation in over 40 countries where there are branches and subsidiaries. He is Secretary of the Hong Kong Branch of the International Fiscal Association, and Chairman of the Taxation Committee of the Hong Kong General Chamber of Commerce. He speaks frequently at tax conferences in Hong Kong, Singapore and elsewhere, and also contributes to tax journals around the world.

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question on 10 separate occasions and often timed these visits in conjunction with the public holidays in Hong Kong. As a result, out of the total of 108 days spent in Hong Kong during the year only 28 were actually spent on business, the balance being spent on leisure.

The relevant part of the Inland Revenue Ordinance that was at issue was Section 8(1B) which reads:

> In determining whether or not all services are rendered outside the Colony for the purposes of subsection (1A) no account shall be taken of services rendered in the Colony during visits not exceeding a total of 60 days in the basis period for the year of assessment.

Counsel for the taxpayer conceded that the taxpayer's income came from a Hong Kong employment because the remuneration came from a Hong Kong entity, but contended, however, that all the services were rendered outside of Hong Kong and for this purpose, visits to Hong Kong on business for periods totalling less than 60 days in the year did not render the taxpayer liable to Hong Kong salaries tax. The legal argument surrounded the question as to whether the words "not exceeding a total of 60 days" qualified the word "visits" rather than the words "services rendered". In his judgement, Mr. Justice Mortimer said that the only reasonable construction was that the legislation was intended to cover visits of any kind provided that services were performed during the visits. Mr. Justice Mortimer confirmed therefore that the "60 days" clearly qualified the word "visits" and therefore allowed the Revenue's appeal.

It would appear therefore that the views of the Revenue have received judicial approval in that a person cannot "visit" the family in Hong Kong without adding the total days used for determining tax liability. This stand had presumably been confirmed in a Board of Review case which has been published as Case DY/821.

A more recent dispute that has addressed the attention of the Courts has been the question of a taxpayer with a foreign employment who renders services outside of Hong Kong. Mr. Justice Macdougall handed down his decision in *Commissioner of Inland Revenue vs George Andrew Goepfert.* This, however, will be the subject of a separate article.

Conference Diary

NOVEMBER 1987

Deutscher Steuerberatertag. München, 2-4 November (German):
Deutscher Steuerberaterverband e.V., Bertha-von-Suttner-Platz 25, 5300 Bonn 1, Federal Republic of Germany.

International Tax Planning Conference in Grand Cayman – a stable and sophisticated offshore financial centre. Grand Cayman, 4-6 November (English):
European Study Conferences Ltd., the Registrar, Douglas House, Queen's Square, Corby, Northants NN17 IPL, United Kingdom.

Doing business between the EC and the COMECON (CMEA) countries. Budapest, 5-6 November (English):
Seminar Services SA, Blvd de Pérolles 7a, CH-1700 Fribourg, Switzerland.

Deutsche Steuerreform – Aussensteuerrecht – Mutter-Tochter-Richtlinie (Steuer-Seminar). Amsterdam, 6 November (German):
Deutsch-Niederländische Handelskammer, Box 80533, 2508 GM Den Haag, The Netherlands, Att. Mr. R.A.E.W. Mehring.

Problems and opportunities in unwinding dual-resident companies. London, 10 November (English):
British Branch of I.F.A., Att. Mr. Eric Tomsett, Touche Ross & Co., Hill House, 1 Little New Street, London WC4A 3TR, United Kingdom.

Annual Take-overs & Mergers Conference. London, 18-19 November (English):
European Study Conferences Limited, Douglas House, Queen's Square, Corby, Northants NN17 IPL, United Kingdom.

In Search of Global Profits: the New Role of Finance. Palm Springs, 18-21 November (English):
Business International Corp., Attn: Lisa Shachtman, One Dag Hammerskjold Plaza, New York, NY 10017, U.S.A.

Multi-National Corporate Tax Report. London, 19 November (English):
International Fiscal Services Ltd, 27 New End, Hampstead, London NW3 1JD, United Kingdom.

Aktuelle BFH-Rechtsprechung zur ertragsteuerlichen Behandlung von Kapitalgesellschaften im In- und Ausland. Bonn, 20 November (German):
bs Gesellschaft für Unternehmerinformation mbH, Mecklenburgerstrasse 5, Postfach 240124, 5300 Bonn 2, Federal Republic of Germany.

Administration of unit trusts. London, 20 November (English):
Oracle Business Information, 31 Gunnersbury Crescent, London W3 9AA. United Kingdom.

De deelnemingsvrijstelling. Amsterdam, 23 November (Dutch):
Euroforum, Antwoordnummer 27, 5600 VB Eindhoven, The Netherlands.

Der Fachkongress der Steuerberater. Köln, 23-25 November (German):
Fachinstitut der Steuerberater e.V., Stresemannstrasse 15, 4000 Düsseldorf 1, Federal Republic of Germany.

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Internationales Steuerseminar Zürich, c/o Bank Leu AG, Postfach CH-8022 Zürich, Switzerland, att. Frau Fleischmann.

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Oracle Business Information, 31 Gunnersbury Crescent, London W3, 9AA, United Kingdom.

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International Fiscal Services Ltd, 27 New End, Hampstead, London NW3 1JD, United Kingdom.

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Euroforum, Antwoordnummer 27, 5600 VB Eindhoven, The Netherlands.

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Euroforum, Antwoordnummer 27, 5600 VB Eindhoven, The Netherlands.

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Management Centre Europe, Postbus 95, NL - 3417 ZH Montfoort, The Netherlands.

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To facilitate ordering, a list of addresses of the main publishing houses is included on pages 46-48 of the January 1986 issue. Addresses of publishers which do not appear in this list are indicated in the item concerned.

ASIA & THE PACIFIC

Australia

AUSTRALIAN MASTER TAX GUIDE
Updater.
Quarterly supplementary updates to annual bound volume.
North Ryde, CCH Australia Ltd., 1987.
Loose leaf service Updater reporting four times a year the significant income tax developments occuring since the last annual edition of the Australian Master Tax Guide.
(B. 56.992)

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CASEBOOK ON INCOME TAX LAW.
Edited by P.N. Bhagwati and M.C. Bijawat.
Bombay, The Bar Council of India Trust; N.M. Tripathi Private Ltd., 1987. 799 pp.
Textbook explaining in brief the relevant statutory provisions of the Indian income tax and containing a large number of cases dealing with the income tax law.
(B. 56.990)

GOYLE, L.C.
Law of Injunctions.
Calcutta, Eastern Law House, 1987. 298 pp.
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Taxation and investment incentives.
Tel Aviv, Kesselman & Kesselman, P.O.B. 452, Tel Aviv 61003.
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Outline of Israeli taxation and U.S. taxation of investment in Israel considered.
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COMPARATIVE TAX SYSTEMS: EUROPE, Canada and Japan.
Editor Joseph A. Pechman.
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Auckland, Commerce Clearing House (New Zealand), 1987.
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NEW ZEALAND INCOME TAX
Legislation.
Auckland, Commerce Clearing House (New Zealand), 1987.
Loose-leaf volume reporting service reproducing the full text of all significant legislation affecting income tax and land tax. The annotated consolidated text of the legislation is updated by supplements. Full text of comprehensive income tax treaties concluded are appended.
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North Ryde, CCH Australia Ltd., 1986. 850 pp., A£ 33.50.
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RAPPORT SUR LA FISCALITE INDIRECTE.
Rapport déposé par le Groupe de travail "Réforme de la Fiscalité et de la Parafiscalité".
Conseil Supérieur des Finances.
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Verslag neergelegd door de Werkgroep "Hervorming van de fiscaliteit en de parafiscaliteit".
Hoge Raad van Financiën.
Brussels, Ministry of Finance, 1987. 72 pp.
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Ein steuerlicher Ratgeber für die Vereine.
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The Argentine Wealth Tax and Its Transborder Effects

or Tax Foreigners – They Have No Vote

By H.A. Sherman

I. OVERVIEW

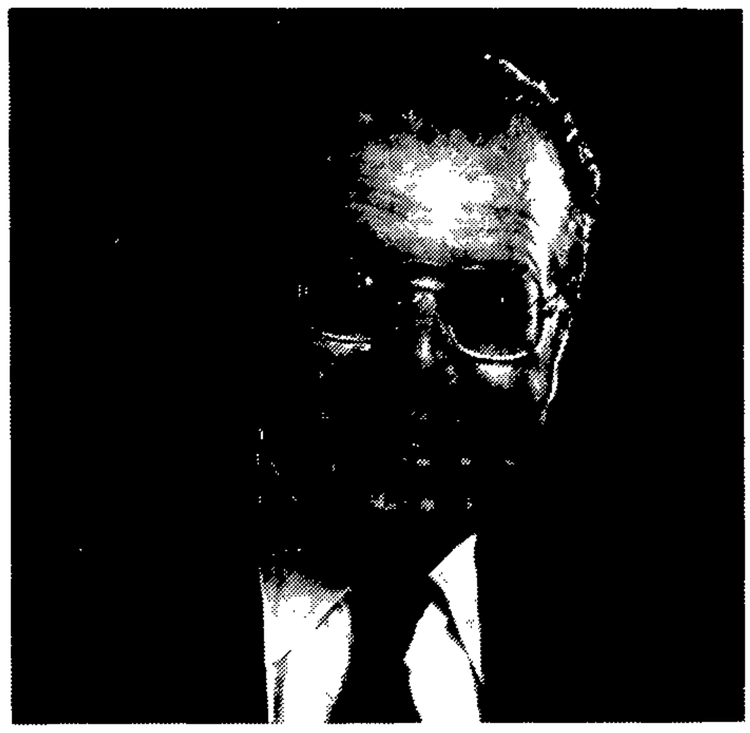
In 1985, the Government of Argentina amended its wealth tax legislation. The consequence was an imposition of wealth tax on individual foreign shareholders having a direct *or an indirect* interest in an Argentine company. Such an indirect interest could include, for example, a foreign individual owning shares in a foreign multinational corporation which has an Argentine affiliate.

Some countries restrict the imposition of wealth tax to residents of the particular country, whereas others also subject non-residents to wealth tax on assets situated in the pertinent country. Even in those jurisdictions where the wealth tax is based on assets within that jurisdiction, tax is imposed on the owner of the assets concerned, *never* on indirect owners.

This new legislation is a clear case of the extraterritorial application of tax law by Argentina. It is dangerous because it creates an unfortunate precedent which may be followed by other developing countries. There are similarities between this new wealth tax and the unitary basis of taxation, imposed by certain U.S. states on subsidiaries of non-U.S. parent companies doing business in those states.

It would obviously not be possible for the Argentine tax authorities to exact the tax from non-resident individuals. Consequently, the new Wealth Tax Law makes every Argentine company with foreign shareholders liable to pay the tax on behalf of the ultimate foreign shareholders. The Argentine company which has paid the tax is given the theoretical right to collect the tax from the individual foreigners on whom it is imposed.

The effect of this new Wealth Tax Law is a piercing of the corporate veil. The law looks through foreign corporations to their shareholders, making these foreign corporations fiscally transparent.



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Mr. Sherman is a frequent speaker at tax conferences and seminars; he has written many articles for professional journals and is the joint author of "Migration – Canada", published in 1985 by Kluwer.

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OPERATION OF THE ARGENTINE WEALTH TAX SYSTEM

Resident corporations are subject to tax on assets located in Argentina at the rate of 1.5%.
Resident individuals are subject to tax on assets (including shares) located in Argentina at rates ranging from 0%–2%.
Non-resident corporations are subject to tax on the value of their permanent establishment located in Argentina at the rate of 1.5%.
Non-resident individuals are subject to tax on assets located in Argentina (including shares issued by Argentine corporations) at a flat rate of 2%.

With respect to shares the following applies:
Resident corporate shareholders owning shares in another domestic corporation are exempt from tax on the value of the shares concerned, but their individual shareholders may credit 1.5% net worth tax against their net wealth tax liability (see below).
Resident individual shareholders are subject to tax on the value of their shares but they may credit the tax paid at the corporate level against their tax liability (result: only where their individual liability exceeds 1.5% they must pay excess tax; note there is no refund for "overpayment" of tax).
Non-resident corporate shareholders are not subject to tax on shareholdings in Argentine corporations; the Argentine corporations, however, must pay 2% tax on behalf of their *non-resident* individual shareholders, subject to a credit for the 1.5% tax paid by the domestic corporation so that the effective tax is 0.5%.
Non-resident individual shareholders are subject to 2% tax on the value of shares issued by Argentine corporations.

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II. BACKGROUND OF THE NEW ARGENTINE WEALTH TAX LEGISLATION

Law 21,282, promulgated on 2 April 1976, provided for a net wealth tax on Argentine residents. This law, however, excepted shares and similar capital participations. The maximum tax rate was 1.5%.

Law 23,297, primarily a revenue-raising measure, was promulgated on 28 October 1985. It made a number of changes to the former law, effective on 31 December 1985. The changes included:

- Imposing a flat 2% rate of wealth tax on non-residents, subject to a credit of up to 1.5% (see below).
- Eliminating the exemption for shares, capital participations, etc.
- An irrebuttable presumption that the taxable assets of non-residents are owned by individuals or estates, even when ownership is through a foreign corporation or other entity. In other words, this provision pierces the (foreign) corporate veil.
- Making local Argentine subsidiaries with non-resident shareholders liable to pay the tax, but with the right to recover such tax from the foreign shareholders on whom it is theoretically imposed. Non-payment of tax would make the Argentine company subject to interest and penalties, even though the company is effectively only treated as the agent of the indirect (individual) foreign shareholders.

A translation of the relevant portion of Art. 14 of Law 23,297 will be found in Appendix A.

It is understood that an opinion has been obtained from Argentine counsel to the effect that this new law is constitutional; any attempt to overthrow it on constitutional grounds would be unlikely to succeed. One key factor in this opinion is that the law applies to Argentine residents as well as to non-residents.

III. BASIS OF TAXATION

The tax is levied on net wealth located in Argentina at 31 December in each year. There are limited exemptions, including federal, provincial and municipal government bonds.

Rules are prescribed for the valuation of property subject to the net wealth tax. These rules are applied to the assets owned by Argentine companies to determine the total value of the company which is subject to the net wealth tax. For example, immovable property is valued at cost, adjusted by inflation indices and reduced by depreciation. A similar basis is applied to some other assets such as cars, boats, airplanes and yachts. Shares and other securities are valued at their quoted prices.

As already noted, the tax is applied at progressive rates from 0 to 2% for residents, but at a flat rate of 2% for non-residents. However, the Argentine company responsible for paying the tax can treat the net worth tax which it pays on its own account as an advance payment, to be credited against the 2% tax.

IV. IMPACT OF THE NEW WEALTH TAX

The wealth tax paid by the responsible Argentine company is not deductible from Argentine taxable income, as the tax is paid on account of non-residents from whom it is theoretically recoverable. Wealth tax so paid may be considered by the Argentine tax authorities to be a distribution of profits to the non-resident and consequently subject to Argentine dividend withholding tax at 17.5%.

An estimate of the gross cost of this tax to an Argentine company (which does not attempt to recover it) is as follows:

Wealth tax paid	100.0
Dividend withholding tax at 17.5% on the gross payment (121.2)	21.2
	121.2
Income tax at 33% on 180.9	59.7
Equivalent pre-tax cost to Argentine company	180.9

This increases the effective *gross* cost of the wealth tax from 2% to 3.6%.

As the regulations to the new wealth tax law have not yet been promulgated, it is not clear that the above calculation is necessarily acceptable to the Argentine tax authorities. Another basis of calculation has been suggested, but the gross cost would not be changed significantly.

It is unlikely that an Argentine subsidiary of a foreign company would seek to recover the tax from the individual shareholders of its parent. Even if it did so and was successful, those individual shareholders, under almost all tax systems, would not be able to claim a tax credit against their domestic tax liability. The tax would be considered to be a capital tax imposed on the local (Argentine) company or, at best, on the corporate shareholder of the Argentine company. Few, if any, taxing jurisdictions permit the piercing of the corporate veil which would be necessary in order that the tax be creditable.

Nevertheless, from the economic viewpoint, the individual foreign shareholder will bear the tax, even when it is not passed on, since it will reduce amounts available to the shareholders in the form of future dividends or capital gains.

V. TAX TREATY CONSIDERATIONS

A. The model treaties

There are two model tax treaties which are relevant:

1. The OECD Model Double Taxation Treaty (1977)

Article 22 of the OECD Model is reproduced in Appendix B. Subsection (4) protects the non-Argentine shareholder from wealth tax.

Even though Argentina is not an OECD member, some of its tax treaties include a provision which is similar to Article 22(4) of the 1977 Model Treaty.

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2. The U.N. Model Double Tax Treaty (1980)

Article 22 reproduces in brackets Article 22 of the OECD Model, with the following comment:

> The Group decided to leave to bilateral negotiations the question of the taxation of the capital represented by immovable property and movable property and of all other elements of capital of a resident of a Contracting State. Should the negotiating parties decide to include in the Convention an article on the taxation of capital, they will have to determine whether to use the wording of paragraph 4 as shown or wording that leaves taxation to the State in which the capital is located.

B. Actual Argentine treaty provisions

The following is a summary of relevant treaty provisions in Argentina's tax treaties:

Austria (entered into force 17 January 1983)

Article 22(4) and (5), reproduced in Appendix B, imposes wealth tax on residents of Austria owning shares or other participations in Argentine companies.

Bolivia (entered into force 4 June 1979)

Article 18 (Net wealth tax) reads:

> Net wealth situated within the territory of one of the Contracting States shall be taxable only by that State.

This will permit Argentina to tax Bolivian residents.

Brazil (entered into force 7 December 1982)

The Argentine wealth tax is not covered by this treaty (see Article II – taxes covered, not reproduced here).

Canada (no treaty)

A draft tax treaty has been initialled, but has not yet been published. It is understood that this draft will not protect the Canadian resident from Argentine wealth tax.

Chile (entered into force 19 December 1985)

Article 19 (Net wealth tax), substantially identical to Article 18 of the treaty with Bolivia (see above), will permit Argentina to tax Chilean residents.

France (entered into force 1 March 1981)

Article 23, reproduced in Appendix B, does not appear to prevent the taxation of French residents.

Germany (entered into force 25 November 1979)

Article 22(4)(a) (reproduced in Appendix B) does not prevent a German resident from being subject to this tax, at least as regards an investment in shares. However, subsection (6), also reproduced in Appendix B, will permit the German resident to reduce the value of his investment by related debt.

Italy (entered into force 15 December 1983)

Article 23 (not reproduced) is substantially identical to OECD Model Article 22 and would therefore protect the Italian shareholder from Argentine wealth tax.

Sweden (effective as of 1 January 1963)

Article I does not list the Argentine net wealth tax as being covered by the treaty. Article XV (reproduced in Appendix B) refers to the future imposition of taxes on capital and sets out the provisions which shall apply. As can be seen, these provisions are ambiguous. The term "capital of a resident of the territory of one of the Contracting Governments" could be construed as relating to capital owned by a Swedish resident, or to the capital of the Argentine subsidiary. Consequently, its effect is indeterminate.

U.S.A. (net yet ratified)

Article 22 is reproduced in Appendix B. This Article may be interpreted by reference to the technical explanation of the treaty prepared by the United States authorities. Relevant parts of the explanation of Article 22 read as follows:

> This Article sets forth rules governing the right to tax various capital assets. . . . Corporate shares and rights may be taxed where the company is resident. These rules do not confer an exclusive taxing right on the State mentioned, but assign the primary taxing right to that State.

Based on that explanation, it would appear that U.S. residents will not be protected from the Argentine wealth tax by the treaty (when ratified).

C. Future tax treaties

Having just imposed this new wealth tax on foreigners, Argentina will almost certainly resist any suggestion from its future treaty partners that it should surrender, by treaty, its right to impose the wealth tax.

VI. PROBLEM AREAS

A number of problems have already been identified in the discussion above:

- Argentina has created unfortunate precedents by the extraterritorial application of its tax law and by improperly piercing the corporate veil of foreign corporations.
- The net wealth tax burden on the individual foreign shareholders at present is comparatively modest after allowing for the credit taken by the Argentine corporation. Further increases in the tax rate are likely as a revenue-raising measure. Such increases, borne by non-residents or by foreign-owned Argentine corporations, would be one of the more politically acceptable methods of collecting tax revenue in Argentina.
- The impact of tax treaties, discussed above, would tend to exempt some individual shareholders of the foreign parent company resident in certain countries. Whether it would be possible in practice to adjust the tax imposed on the Argentine subsidiary by reference to the residence of shareholders of the foreign parent is moot. It would certainly result in severe collection complexities.

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- In almost all cases, the Argentine wealth tax paid could not be credited against the tax liability in the foreign shareholder's country of residence.

VII. NON-TAX SOLUTIONS

Certain countries may have domestic legislation which will permit that action be taken to help their residents to avoid liability to Argentine wealth tax.

For example, Canada has the Foreign Extraterritorial Measures Act. Section 5 can be used if another country takes measures affecting international trade or commerce which are likely adversely to affect significant Canadian interests involving business carried on in Canada, or which infringe on Canadian sovereignty. One possible remedy would be for the Attorney General of Canada to prohibit the Canadian parent from complying with Law 23,297.

There are two obvious difficulties in attempting to take advantage of this legislation. The first is to persuade the Attorney General that the problem is of such magnitude that use of this provision is justified. The second is that such a prohibition is unlikely to prevent the Argentine authorities from collecting tax from the local subsidiary.

VIII. CONCLUSION

The new Argentine legislation appears to have generated little or no international interest. This may be the first article published on the subject in a professional tax journal outside Argentina. It is believed that many of the companies adversely affected have concluded that they have no alternative but to pay the tax demanded. They treat it as yet one more cost of doing business in Argentina. This is an unfortunate approach. A co-ordinated attack on this new law by those adversely affected, and by their Governments, might force the Argentine Government to reconsider the consequences of what they have done.

A foreign company planning to invest in Argentina and, indeed, encouraged to do so by the Argentine authorities, may reconsider in the light of this unfair new wealth tax. It is surprising that a country so dependent on foreign investment would impose extraterritorial taxation. One may even wonder about the impact of this wealth tax legislation on international aid programmes once donating Governments realize that the country which they are helping is, in return, imposing extraterritorial taxation on their nationals.

The action of the Argentine Government in imposing this new tax runs counter to international tax norms and is to be deplored. Those multinational corporations which are aware of the problem and yet have taken no steps to draw the problem to the attention of their Governments must bear part of the responsibility for the continued imposition of this wealth tax. It would not be unreasonable for Argentina to assume that, since foreign multinationals and their Governments have not complained, it is acceptable to them.

If the matter is allowed to rest, other developing countries will no doubt follow the Argentine example, once they realize that it will produce a significant source of revenue at the expense of uncomplaining foreigners.

APPENDIX A

ARGENTINE LAW 23,297 PROMULGATED 28 OCTOBER 1985

(as it is incorporated in the consolidated text of Tax Law 20,628 by Decree 450 (Official Gazette of 1 September 1986))

Article 14*

Individuals and estates located abroad who own assets within the country, directly or indirectly, through the ownership of the share capital of companies, etc. are subject to this Article. Those subject to the provisions of this Article include the above-mentioned taxpayers who are the direct or indirect owners of debt-claims, including those guaranteed by rights over assets situated in Argentina.

For the purposes of the preceding paragraph, there is a legal presumption, without the right of rebuttal, that the assets mentioned in the previous paragraph – including participation in the capital of companies . . . located . . . in the country – whose shareholders are companies . . . located abroad, belong indirectly to individuals or estates domiciled abroad.

For the above purposes, individuals, estates, corporations, etc. who have the possession, use, enjoyment, availability, custody, etc. of assets in Argentina subject to the tax which belonged to individuals or corporations, etc. abroad must pay, as responsible substitutes, a final payment at 31 December of each year at the rate of 2% of the respective value of the assets, established in accordance with this law.

* Author's translation of relevant portions of Article 14. See next page for the (complete) Spanish text.

APPENDIX B

OECD MODEL DOUBLE TAXATION TREATY ON INCOME AND ON CAPITAL (1977)

Article 22
Capital

1. Capital represented by immovable property referred to in Article 6, owned by a resident of a Contracting State and situated in the other Contracting State, may be taxed in that other State.
2. Capital represented by movable property forming part of the business property of a permanent establishment which an enterprise of a Contracting State has in the other Contracting State or by movable property pertaining to a fixed base available to a resident of a Contracting State in the other Contracting State for the purpose of performing independent personal services, may be taxed in that other State.
3. Capital represented by ships and aircraft operated in international traffic and by boats engaged in inland waterways transport, and by movable property pertain-

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Art. 14.— Las personas de existencia visible domiciliadas en el exterior y las sucesiones indivisas radicadas en el extranjero, que resulten titulares directos de bienes en el país o que los posean de manera indirecta a través de participaciones en el capital social o equivalente de sociedades, empresas, establecimientos estables, patrimonios de afectación o explotaciones domiciliados o, en su caso, radicados o ubicados en el exterior, quedan sujetos a las disposiciones del presente artículo. Sin perjuicio de ello, en el caso de créditos, sólo quedarán sujetos a sus disposiciones los contribuyentes mencionados que resulten titulares directos o indirectos de créditos, incluso los garantizados con derechos reales sobre bienes situados en el país, contra personas físicas domiciliadas en el país o sucesiones indivisas radicadas en el mismo.

A los efectos previstos en el párrafo anterior, se presume de derecho, sin admitir prueba en contrario, que los bienes en él mencionados —incluidas las participaciones en el capital de empresas, sociedades, establecimientos estables y explotaciones constituidos, domiciliados, ubicados o radicados en el país— cuyos titulares sean sociedades, empresas, establecimientos estables, patrimonios de afectación o explotaciones domiciliados o, en su caso, radicados o ubicados en el exterior, pertenecen de manera indirecta a personas físicas domiciliadas en el exterior o a sucesiones indivisas allí radicadas.

A los fines indicados precedentemente, los contribuyentes del impuesto sobre los capitales, las sucesiones indivisas radicadas en el país y toda otra persona de existencia visible o ideal domiciliada en el país que tenga el condominio, posesión, uso, goce, disposición, depósito, tenencia,custodia, administración o guarda de bienes sujetos al impuesto que pertenenzcan a personas de existencia visible o ideal, establecimientos estables, patrimonios de afectación, empresas o explotaciones unipersonales o a sucesiones indivisas domiciliados o, en su caso, radicados o ubicados en el extranjero, deberán ingresar, como responsables sustitutos, y con carácter de pago único y définitivo, por los respectivos patrimonios al 31 de diciembre de cada año, el dos por ciento (2%) del valor respectivo de los bienes, determinado de acuerdo con las normas de la presente ley. En el caso en que el patrimonio gravado se hallare constituido por bienes a los que se refieren los incisos c) y d) del artículo 6º, corresponderá el cómputo, como pago a cuenta del gravamen, del importe que resulte por aplicación de lo dispuesto en el tercer párrafo del artículo 13, con la salvedad de lo dispuesto en el cuarto párrafo del mismo.

La obligación de actuar como responsable sustituto también corresponderá a los entes sociales, por las participaciones en su capital que pertenezcan, de manera directa o indirecta, a los sujetos pasivos del gravamen mencionados en el párrafo primero de este artículo. La actuación del ente como responsable sustituto excluye la prevista respecto de los responsables sustitutos mencionados en el párrafo precedente, sin perjuicio de la que corresponda a estos últimos como agentes de información, de acuerdo con las normas que al respecto dicte la Dirección.

También serán reponsables del ingreso del impuesto, conforme al régimen de este artículo, las personas de existencia visible domiciliadas en el país y las sucesiones indivisas radicadas en el mismo, con respecto a los créditos, incluso los garantizados con derechos reales sobre bienes situados en el país, que contra las mismas posean directa o indirectamente al 31 de diciembre de cada año, las personas de existencia visible domiciliadas en el exterior y las sucesiones indivisas allí radicadas. Los responsables obligados al ingreso del gravamen tendrán derecho a reintegrarse el importe abonado, incluso reteniendo y/o ejecutando directamente los bienes que dieron origen a aquél.

No corresponderá efectuar el ingreso establecido en este artículo si:

1) El titular inmediato de los bienes o de los créditos fuera una persona de existencia ideal de derecho público extranjero o internacional;

2) El titular inmediato de los bienes o de los créditos fuera una persona de existencia ideal exenta por las leyes nacionales o por convenios internacionales aplicables, en la medida y por las limitaciones establecidas al efecto; o

3) El ingreso a realizar fuera inferior a dos australes (₳ 2.-).

ing to the operation of such ships, aircraft and boats, shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.

4. All other elements of capital of a resident of a Contracting State shall be taxable only in that State.

ARGENTINA–AUSTRIA TAX TREATY

Article 22
Capital

4. Capital represented by shares shall be taxable only in the State of which the company issuing the shares is a resident. Capital represented by bonds and debentures shall be taxable only in the State of which the debtor thereof is a resident.
5. Capital represented by other participations in companies shall be taxable only in the State under the law of which the company was established.

ARGENTINA–FRANCE TAX TREATY

Article 23
Capital

1. Capital represented by immovable property referred to in Article 6, owned by a resident of a State and situated in the other State, may be taxed in that other State.
2. Capital represented by movable property forming part of the business property of a permanent establishment which an enterprise of a State has in the other State or by movable property pertaining to a fixed base available to a resident of a State in the other State for the purpose of performing independent personal services, may be taxed in that other State.
3. Capital represented by ships and aircraft operated in international traffic and movable property directly pertaining to such activities shall be taxable only in the State in which the place of effective management of the enterprise is situated.
4. All other elements of capital shall be taxable according to the legislation of each State.

ARGENTINA–GERMANY TAX TREATY

Article 22
Capital

4. The following elements of capital of a resident of a Contracting State shall be taxable in the other Contracting State:
   (a) shares of a company resident in that other Contracting State;
6. Where, in accordance with the above provisions of this Article a Contracting State has the right to tax an element of capital, debts effectively connected with that element of capital may for the purposes of determining the taxable base be allowed as a deduction provided that the tax is levied on the net worth of such element of capital.

ARGENTINA–SWEDEN TAX TREATY

Article XV

Where taxes on capital are imposed by one or other or both

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of the Contracting Governments the following provisions shall apply:

(a) Capital represented by real property shall be taxable only in the territory of the Contracting Government in which such property is situated.

(b) Subject to the provisions of paragraph (a) above, capital represented by assets forming part of the business property employed in a permanent establishment of an enterprise, shall be taxable only in the territory of the Contracting Government in which the permanent establishment is situated.

(c) Ships and aircraft operated in international traffic and assets, other than real property, pertaining to the operation of such ships and aircraft, shall be taxable only in the territory of the Contracting Government of which the enterprise is a resident.

(d) All other elements of capital of a resident of the territory of one of the Contracting Governments shall be taxable only in that territory.

ARGENTINA–U.S.A. TAX TREATY

Article 22
Taxation of capital

1. Capital represented by immovable property referred to in Article 6 (Income from immovable property), owned by a resident of a Contracting State and situated in the other Contracting State, may be taxed in that other State.

2. Capital represented by movable property forming part of the business property of a permanent establishment which an enterprise of a Contracting State has in the other Contracting State, or by movable property pertaining to a fixed base available to a resident of a Contracting State in the other Contracting State for the purpose of performing independent personal services, may be taxed in that other State.

3. Capital represented by ships and aircraft operated by a resident of a Contracting State in international transport and movable property pertaining to the operation of such ships and aircraft shall be taxable only in that State.

4. Capital represented by ships or aircraft (other than those referred to in paragraph 3) and motor vehicles may be taxed in the State in which the ships, aircraft or motor vehicles are documented or registered.

5. Capital represented by shares or other corporate rights may be taxed in the Contracting State of which the company is a resident.

6. Capital represented by tangible personal (movable) property other than property referred to in the preceding paragraphs may be taxed in the Contracting State in which the property is located.

7. All other elements of capital of a resident of a Contracting State shall be taxable only in that State.

Albert-Hensel-Prize

The Albert-Hensel-Prize was instituted to commemorate Albert Hensel (1895-1933) one of Germany's most important pioneers of tax law theory. The prize is awarded to young authors who have written an outstanding – as yet unpublished – work (e.g. a doctoral thesis) in the field of tax law relating to legal, economic or financial aspects. The prize consists of 5,000 DM and the right to have the manuscript published in the series "Steuerwissenschaft" by Dr. Peter Deubner Verlag in Cologne (Federal Republic of Germany).

On 22 September 1987 the 1987 *Albert-Hensel-Prize* was bestowed by Professor Dr. Franz Klein, President of the Supreme Tax Court of the Federal Republic of Germany, on Dr. Michael Engelschalk for his doctoral thesis entitled "Die Besteuerung von Steuerausländern auf Brutobasis" (The taxation of non-residents on gross income).

Dr. Peter Deubner Verlag has decided to award the *Albert-Hensel-Prize* also in 1988. Candidates must contact the Editorial Board of "Steuerwissenschaft" before 31 May 1988 and address any correspondence to Prof. Dr. Heinz Mösbauer, Postbox 41 02 68, 5000 Cologne 41, Federal Republic of Germany.

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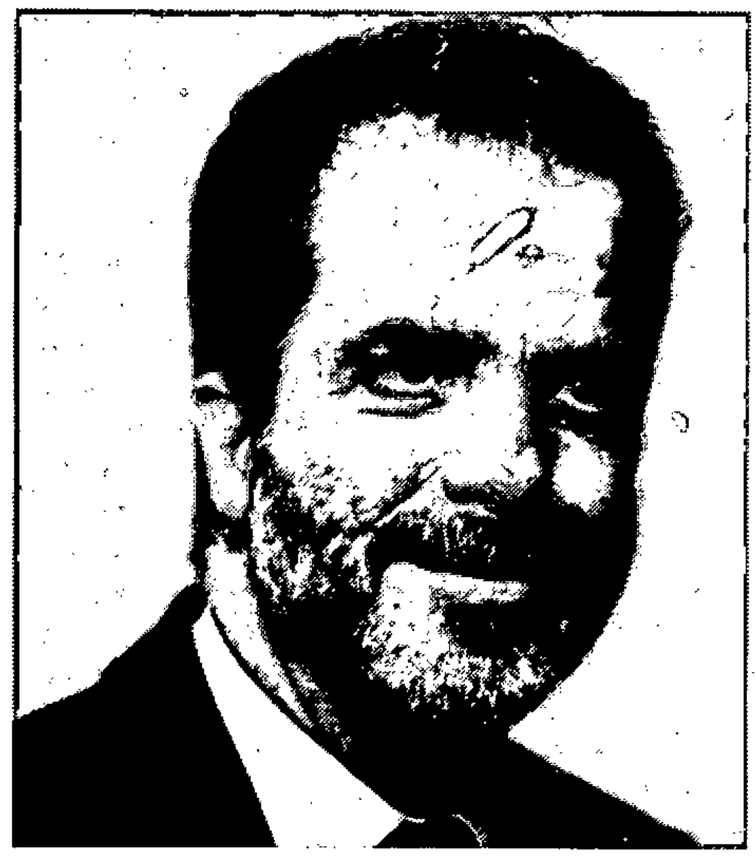
MOROCCO:

Present Status of Taxation Including Recent Tax Reform

By Jean-Marc Tirard



I. INTRODUCTION

Morocco is located in the northwest corner of the Maghreb and has two seacoasts, one on the Atlantic and the other on the Mediterranean. The country has a surface area of 710,850 square kilometres, and a population of 20.4 million according to the 1982 census (expected to rise to 35 million by 2000). The official language of Morocco is Arabic; French is also very widely spoken.

Morocco is a constitutional monarchy. The king is the incumbent chairman of the Islamic Conference, of the Al Qods committee, and the Committee of Seven responsible for explaining the Fez Peace Plan of 1982 to the Middle East.

The currency unit is the dirhan (DH), officially only negotiable in Morocco.

The Moroccan economy, although still dominated by agriculture and mining, is undergoing rapid industrialization. Morocco offers considerable incentives to local and foreign investors. It has signed a number of agreements guaranteeing investments. Tax, customs and financial incentives are contained in codes designed to encourage investment.

Currently, the main codes include the Industrial Investment Code (January 1983), the Tourism Investment Code (June 1983), the Maritime Investment Code (October 1984), the Export Activity Code (August 1973), the Real Estate Investment Code (August 1985), and the Mining Investment Code (December 1986).

Morocco is attempting to encourage exports of its products and has signed a large number of trade agreements. It joined the GATT on 17 June 1987, and will apply the tariffs set by this organization. The wave of tax reforms around the world has reached Morocco, and the Government has been working on an overhaul of the tax system for slightly more than a year. The system now resembles the French system through the introduction of VAT, corporate tax and, soon, general individual income tax.

The first step in this sweeping reform was the introduction of VAT in April 1986, which was not accomplished without controversy and heated discussion. The main innovation of the law relating to VAT lies in the fact that it is applicable to importers and, above all, wholesalers, who had previously been exempt from the old tax on products and services (TPS). Furthermore, the law has clearly and significantly simplified the tax rates in comparison to the product and services tax; there are now only five categories, as opposed to eleven in the past. Generally speaking, the number and amount of VAT rates in Morocco are relatively high in relation to some EEC countries; this results from the particularly uneven income structure.

Just over a year after its inception, VAT does not seem to have caused any inflation, but its application to wholesalers and retailers poses a great many problems.

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The author would like to thank his assistant, François Beglin, for his aid in the preparation of this article.

A completely revised and updated description of Morocco's tax system has been published in French and in English in the IBFD's loose-leaf services *Systèmes Fiscaux Africains/African Tax Systems.*

For further details please contact Mr. Robin King, publication manager, or Mrs. Butzelaar, editor, c/o International Bureau of Fiscal Documentation, Postbox 20237, 1000 HE Amsterdam (telex: 13217 INTAX NL; telefax: 020 - 22 86 58).

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The second step of the reform was the introduction of corporate tax on 21 January 1987; it replaces the tax on professional income. Corporate tax law explains and clarifies certain conditions relating to tax on professional income for determination of taxable income, and applies a single tax rate (45%). Taxes are thus lowered for those companies whose professional income was exceeding 250,000 DH. Our study will examine this tax with all the prudence required when confronted by new tax regulations.

The third and final step of the tax reform will be the introduction of general income tax, scheduled for debate during the fall session of Parliament. Its main consequence will be the amalgamation of income tax on agriculture, wages, property and investment capital into one tax with a single schedule of progressive rates.

Implementation of this major tax reform will raise problems with regard to the so-called underground economy. The traditional economy comprises a significant invisible sector that is not taxed.

In contrast, the reform has been well accepted by major companies, since it clarifies the tax regulations and increases the rights of the taxpayer in case of a tax audit.

This article will mention the conditions under which an activity may be set up in Morocco and subsequently examine the different taxes to be paid by a company before giving a brief outlook on the taxation of individuals.

II. CONDITIONS FOR SETTING UP IN MOROCCO

A. Exchange control regulations and authorization requirements

In principle one can invest freely in industrial and commercial activities, however, each investor must, in practice, obtain the agreement of the Moroccan Exchange Control Office.

This written agreement issued by the local authorities provides for two fundamental guarantees: firstly, the ability to transfer the dividends relating to the activity's profits, and, secondly, in the event of a capital transfer or liquidation, to repatriate the capital invested and the consequent capital gains.

It should also be noted that certain investments can benefit from either a partial or total exemption from corporate tax and also full exemption from customs duties on equipment imported for the purpose of establishing the activity. These exemptions can only be obtained upon application from the proper authorities.

The agreement is easily obtained from the Moroccan Exchange Control Office within a delay of one month when it is requested for setting up an industrial subsidiary. However, agreement for establishing a branch or for purely commercial investment is more difficult to obtain.

B. Legal aspects: Morocconization Law

The subsidiaries of foreign companies established in Morocco benefit from the same rights available to Moroccan corporations. If the subsidiary of a foreign corporation has its registered offices in Morocco it is considered as a Moroccan company.

One restriction only exists and this is the Morocconization Law (Dahir) of 2 March 1973. According to this law certain activities, essentially relating to non-industrial activities (as prescribed in a listing in the Decree of 8 March 1973), can only be carried out by Moroccan individuals or companies. In the case of a stock company at least half the company's capital has to be held by Moroccan nationals and the majority of its directors, the president of the board, and the managing director (administrateur délégué) have to be Moroccan nationals.

It should be noted that the Moroccan administration applies this law with great rigour.

In the sector of activities not affected by this law the companies can be wholly foreign owned.

Moreover, in case of an international bid, even in a sector of activity falling under the Morocconization Law, this law does not apply.

III. THE TAX SYSTEM

A. Taxation of profits

This section will consider the tax regime applicable to foreign companies that carry out industrial and commercial activities in Morocco, and to those which merely make profits without actually being located there.

Taxation of industrial and commercial activities

The tax system applicable differs greatly depending upon whether the foreign company is established under an investment code or simply under common law.

a. Investment codes

(a) The 1983 Industrial Investment Code (Dahir No. 1.82.220 of 17 January 1983) contains various measures to encourage investment in Morocco:

- new industrial companies that locate in certain provinces generally distant from harbours, are either completely exempted from, or given a 50% reduction in, corporate tax for the first 10 years of operation;
- industrial service companies are exempted from this tax for their first 10 years of operation, no matter where they are located;
- industrial or industrial service companies may make a tax-free reserve for some of their investments.

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(b) Dahir No. 1.73.408 of 13 August 1973 introduced measures to encourage industrial or craft export companies that can be added to those contained in the 1983 Industrial Investment Code.

A few sectors of activity, however, cannot benefit from this favourable treatment.

Export companies benefit, within the limits of export turnover, from a total exemption from the corporate tax. This scheme normally expires on 31 December 1987, but should be renewed. This exemption was extended in a few cases to cover exports by commercial companies, provided that their annual export turnover exceeds 10 million DH.

The investment codes contain many other advantages that will be discussed later.

b. General law systems

(i) *Taxation of real income*

Most companies are subject to corporate tax since publication of the Dahir of 31 December 1986. Tax on professional income continues to be applied primarily to partnerships, joint ventures and limited partnerships between individuals. However, these legal entities may elect for corporate tax. Until individual income tax is introduced, it will still be applicable to individuals exercising an industrial or commercial activity.

Other than changing the tax rate, the introduction of corporate tax has not changed the method used to determine tax; its application is primarily intended to clarify existing provisions concerning tax on professional income, which were sometimes confusing, and to modify methods for collecting taxes and the procedures applicable in the event of a tax audit.

Thus, if the solutions previously used for tax on professional income are applicable to corporate tax, a certain number of new measures, often more favourable to companies, were enforced. Nevertheless it is worthwhile mentioning that late payment penalties have been increased.

Morocco applies taxes territorially. Thus, subject to the application of international agreements, foreign companies must pay corporate tax in Morocco when they exercise an activity there through an establishment (a construction or assembly site is considered to be an establishment) or a dependent representative, or when they carry out a complete commercial cycle in Morocco. It should be noted that operations may be taxed even if they are only occasional.

Corporate tax is mandatorily determined in accordance with the real net income determined by regular accounting. The corporate tax law explains and clarifies the concept of taxable income defined by the law on taxation of professional income. Taxable income is the net income – including windfalls – earned during the mandatory 12-month period covered by the most recent balance sheet. This net income consists of the gross income surplus over costs and expenditures incurred or committed for the needs of the company in order to earn a taxable income.

Deductible expenses include:

- *personnel expenses* (including employer contributions to social security and pension funds)
- *depreciation*
  Only the straight-line method of depreciation is used in Morocco. Under some exceptional circumstances, exceptional depreciation may occasionally be reported. The law requires depreciation to be reported annually. Setting-up expenses can be deducted from the earnings of the first fiscal year for which a profit is declared, or depreciated over a period of 5 years.
- *provisions*
  Provisions can be deducted from earnings if certain basic conditions are met:
  - the provisions are established to meet losses or tax deductible expenditures,
  - the losses or expenditures are clearly specified,
  - the losses or expenditures are likely to be incurred,
  - the probability of losses or expenditures results from events in progress,
  - the provisions are entered in the accounts for the fiscal year.

  In practice, the Tax Administration applies these conditions very strictly.
- *taxes*
  Taxes can be deducted from the taxable income subject to corporate tax, with the exception of corporate tax itself and the contribution to national solidarity.
- *financial expenditures*
  Financial expenditures, including interest paid to partners for money loaned by them to the company for operating needs, are deductible provided that the capital stock is fully paid up. However, the total amount of the sums bearing interest cannot exceeds the amount of the capital stock, and the rate of deductible interest cannot exceed the prime rate of the Bank of Morocco for the rediscount of private instruments plus 2 points (10.5%).

At the end of the fiscal year the stocks shall be evaluated at cost or at the quoted market price if this price is less than cost.

Capital gains earned on the sale of assets are in principle taxable as ordinary income. Capital losses are deductible from income.

However, capital gains may benefit from discounts on options (25 or 50% depending upon the duration of the holding) or even a total exemption in the event of reinvestment of the revenues from the assignment within a period of 3 years.

Dividends and other shareholding revenues from distribution of income by companies subject to corporate tax benefit from an abatement of 85%.

Net losses reported at the end of the fiscal year can be carried over onto the revenues of the 4 following fiscal

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years instead of the 5 years allowed under the system for tax on professional income.

This limitation does not cover the portion of the deficit corresponding to regularly practiced depreciation. These tax losses may be carried over without any time limitation.

Tax is payable at a rate of 45%. To this 45% is added a "contribution to national solidarity" (to finance the war effort) equal to 10% of the corporate tax itself. Thus, the actual total corporate tax is 49.5%.

Half the tax must be paid when the annual declaration is filed (i.e. within 3 months of the year-end), and the balance is due within the following 2 months.

In any case there is a minimum corporate tax to be paid. It is based on the turnover and cannot exceed 100,000 DH. It is deductible from corporate tax of the relevant tax year.

(ii) *Lump-sum taxation of turnover*

Foreign companies that have successfully bid on work, construction or assembly contracts may choose to pay a lump-sum tax of 13.2% on the total amount of the contract. It provides exemption from corporate tax, the tax on share or stock revenue. This option can be exercised separately for each contract.

In case of a "turnkey contract", the taxable base includes the cost of incorporated materials and installed equipment, whether they are supplied by the company that won the contract or on its own behalf, invoiced separately, or cleared by the owner. Although this simplification seems to be of interest, the tax rate is sufficiently high to ensure only companies with the very large margins will find it of interest.

Chart: Moroccan tax on passive investment income

States	Dividends	Interest	ROYALTIES Copyright of literary, artistic or scientific works	Others
Belgium	15%	15%	5%	10%
Canada	15%	15%	5%	10%
France	–10*–	–12*–	5%	10%–13*–
Germany	–1*– –15%	10%	10%	10%
Italy	–2*– –15%	10%	5%	10%–13*–
Luxembourg not ratified	–2*– –15%	10%	10%	10%
Netherlands	–2*– –25%	–3*– –25%	10%	10%
Norway	15%	10%	10%	10%
Romania not ratified	15%	10%	10%	10%
Spain	–4*– –15%	10%	5%	10%
Sweden	–7*–	–9*–	–9*–	–9*–
Tunisia	–8*–	–11*–	–9*–	–9*–
United Kingdom not ratified	–5*– –25%	10%	10%	10%
U.S.A.	–6*– –15%	15%	10%	10%

1* 5% if the recipient is a company holding directly at least 25% of the capital
25.75% if the receiving company is resident in Morocco and holds at least 25% of the capital of the company paying the dividends
2* 10% if holding is at least 25% of the capital
3* 10% if it is paid by a resident of a State to a company of another State
4* 10% if the recipient is a company holding at least 25% of the capital of the company paying the dividend
5* 10% if the holding is at least 10% of the capital
6* 10% if the beneficiary owns 10% of the company distributing the dividend and if certain other conditions are met (duration of ownership type of income being distributed)
7* Usually taxable only in the State of which the recipient is a resident
8* May be taxable in the State of which the company paying the dividends is a resident
9* Taxable only in the State of the recipient
10* Taxed in Morocco at ordinary rate for dividends – no withholding tax in France
11* Taxable in the State where such interest is paid with exemption or tax credit in the other country
12* Taxed in Morocco at ordinary rate for interest – withholding tax in France limited 10%
13* Royalties derived from real estate, working of mines or natural ressources are taxable only in the State where they are located

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(iii) *Taxation of distributed income*

In Morocco, a tax on share or capital income and assimilated income exists. It is applicable to:
- dividends and all other income from shares of any type, founder's shares, etc.;
- all revenue equivalent to profit-sharing;
- earnings in Morocco from branches of companies whose head offices are located abroad, when these earnings are effectively transferred abroad to the companies.

The tax rate is 25% and is withheld at the source by the party paying the tax.

In addition, any transfer of dividends or distribution of profits is subject to prior authorization by the Foreign Exchange Office, which in all cases makes authorization conditional upon prior payment of the sum withheld at source.

For the application of international agreements and their effect on the tax rate see the above chart.

Accordingly, profit distribution is treated in the same way regardless of whether the foreign company operates in Morocco through a branch or whether a subsidiary has been created.

c. Taxation of profits generated in Morocco by companies not located in Morocco

We will first examine the tax system applicable to the company's income (royalties, interest, fees, etc.) under domestic law before examining application of international tax treaties.

(i) *Application of domestic law*

Articles 3.11 and 3.12 of the Dahir of 31 December 1986 introducing corporate tax specify that foreign companies receiving certain revenues as defined by law are subject to corporate tax through withholding at the source at a reduced rate of 10%. The revenues covered are:
- royalties for the use or right to use copyright on literary, artistic or scientific works;
- royalties for the transfer of patent operating licences, drawings and models, drawings formulae and secret processes, trade marks;
- fees for technical assistance or temporary assignment of personnel;
- rental rights and similar income from equipment of any kind;
- interest on loans;
- commissions and fees.

It is important to note that any contract with a Moroccan partner comprising transfer of funds abroad must first be approved by the Foreign Exchange Office, which is very strict in this regard.

The only contracts likely to obtain this type of authorization are those involving high technology or the supply of highly qualified personnel not available on Moroccan markets.

In addition, authorizations are granted for a set period of time and are not automatically renewed, especially if it seems that the Moroccan partner no longer requires foreign contributions.

(ii) *Application of international tax treaties*

Morocco has negotiated and signed a relatively large number of tax treaties. Tax treaties currently in force have been signed with Finland, Sweden, Tunisia, the Federal Republic of Germany, France, Belgium, Canada, Norway, the United States, Italy, Spain and the Netherlands. Treaties have been signed, but not ratified with Romania, Libya and the United Kingdom; still others have been ratified, but are not yet in force (Luxembourg and Denmark).

The Chart above lists the applicable rates given in the treaties.

B. Other taxes

1. Trading tax

The trading tax is an old tax based on production facilities that is applicable to both individual persons and companies who exercise an industrial, commercial or professional activity in Morocco. It is deductible from corporate tax. This tax comprises a proportional tax varying from 5 to 30% of the gross rental value of the professional premises and a variable tax of 10 to 20% applied to certain professions.

However, this tax cannot be less than the minimum levels set by the law.

The investment codes provide for temporary tax exemptions for new companies that are located in certain areas of Morocco and for real estate and property developers.

The burden of this tax is significant only in case of very substantial investments.

2. Tax on interest

This tax is levied on interest received by any individual or legal entity resident in Morocco. It is based on the interest's gross amount. The applicable rate is 15% or 20% depending on whether the beneficiary gives his name or not. This tax is deductible from either corporate tax or the complementary contribution in the case of an individual.

3. Value added tax (VAT)

VAT has recently been introduced in Morocco and came into force in April 1986 after numerous simulations to determine the best tax rates.

This reform was based on the following principles: creation of unified taxation, extension of VAT to wholesalers and import traders, limiting the number of tax rates, widening and modifying the deduction scheme, increase in the taxpayer warranties in case of a tax audit, and introduction of significant adjustments relating to tax basis, exemptions and penalties.

If it is too early to draw a conclusion on this reform, it

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has nevertheless to be stated that it created no inflation as it replaced different indirect taxes which were not deductible previously. However, the tax yield from the VAT is lower than the one from the previous tax on products and services.

The underlying principle of this tax is based on the French VAT system. All industrial, wholesale, craft and professional activities carried out in Morocco and all import and delivery transactions are subject to VAT.

Agricultural, retail, non-industrial and non-commercial activities and "civil acts" are not subject to VAT.

Also exempt from VAT are operations involving essential commodities, the activities of small manufacturers and suppliers of services whose annual turnover is less than or equal to 120,000 DH (approximately 87,000 Ffrs.) and transactions by wholesalers whose turnover for the previous year is less than 3,000,000 DH (approximately 2,176,000 Ffrs.).

Export companies in Morocco do not have to pay VAT on products to be exported or placed under the "suspensive customs system", i.e. remaining within customs bonds. In addition, these companies can request authorization to receive the goods and raw materials required for their operations without paying VAT on them.

VAT is due when the goods or services sold are paid for. However, the companies liable for tax may opt to pay the VAT on invoices.

VAT can be recovered the same month as it is paid for assets, and the following month for services and goods other than assets. The VAT to be paid is the difference between the VAT due and the refundable VAT.

In principle, VAT credits are not reimbursable except in case of a liquidation or if these credits stem from VAT exemptions on exports. In order not to penalize new companies, the equipment and tools that they purchase are not subject to VAT if they benefit from investment incentive measures.

Five VAT rates are applicable in Morocco:
- the super-low rate (7%), primarily applicable to widely consumed products and operations involving the transportation of people and goods;
- the reduced rates (12 and 14%); the 12% rate is applicable to food eaten on the spot, hotel and tourist accommodation rentals, banking, credit and exchange operations. It also applies to certain operations such as telephone telex services, insurance brokerage and the fees received by professionals for whom VAT is not recoverable; the 14% rate is applicable to real estate work;
- the normal 19% rate is applicable to all taxable transactions for which another rate is not expressly provided for under the law;
- the 30% luxury goods rate;
- special rates.

Taxing of those who are liable for VAT takes the form of a monthly declaration or a quarterly declaration. The tax is paid when the form is presented or sent.

In order to check the VAT due, the taxpayers must keep accounts.

The application of VAT in Morocco, with its very traditional economy, part of which does not pay tax, poses major problems. Applying VAT to wholesalers seems particularly difficult. Quite often most of their activity takes place without invoicing and does not involve tax.

As a result, Moroccan VAT has undergone some changes in relation to the French system: exemptions take into account the structure of the economy. Unlike the French VAT system, the common law VAT system considers that a single event, receipt of payment, gives rise to application of VAT.

Finally, as a simplification, the quarterly VAT declaration is a widespread practice in Morocco. This tax system is automatic for taxpayers whose taxable turnover is less than 1,000,000 DH (approximately 725,000 Ffrs.).

4. Registration duties

The creation of companies or the increase of their share capital results in the application of a duty equal to 1.5% of the capital for ordinary contributions, increased by a surtax in the event of contribution in kind. A notarial tax that decreases in relation to the amount of capital (1 to 0.2%) and a 1% stamp duty are also due by limited liability companies.

However, companies benefiting from the clauses of the 1983 Industrial Investment Code are only subject to a 0.5% fee and may be exempt from the surtaxes.

Transfer of shares, in case of a written agreement, are subject to a 2.5% stamp duty based on the value of these shares.

Building acquisitions are generally subject to a 7% to 15% registration duty.

5. Urban tax and municipal administrative tax

The urban tax and the municipal administrative tax are based on the rental value of the building constructed, the undeveloped property and production facilities for industrial and commercial use located in urban areas. The urban tax is 13.5% for companies subject to corporate tax, and the municipal administrative tax varies from 1 to 10%. New facilities for professional use are exempt from the urban tax for 3 to 5 years and 15 years under the terms of the Real Estate Investment Code. These two taxes also apply to rental income received by individuals.

C. Individual income tax

The goal of the tax reform which is expected to be examined before the end of 1987 is to simplify the tax system and spread the tax burden on a more equitable basis.

The debate in the Moroccan Parliament will probably focus on the tax rates to be implemented. Even if

[continued on page 553]

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THE MARIANA ISLANDS:

An Update on Taxation

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The U.S. Congress finally took a giant leap toward tax reform in the U.S. possessions by repealing the requirement that the possessions impose a so-called mirror-image of the U.S. Internal Revenue Code (I.R.C.) of 1954, *as amended,* as their local system of taxation.[1] The mirror-image system is so named because the I.R.C. is to be applied as the local income tax code by substituting the name of the possession for the name "United States" where appropriate, and by treating the U.S. as a foreign country. This article will focus on the current system of taxation in the Commonwealth of the Northern Mariana Islands (the "CNMI") and its relationship with the I.R.C. of 1986.

The CNMI entered into a Commonwealth with the U.S. in 1976 upon the signing into law of the Covenant to Establish a Commonwealth of the Northern Mariana Islands (Covenant).[2] Sec. 601(c) of the Covenant imposed the mirror-image system on the CNMI.[3] For some time, the CNMI resisted the imposition of the mirror-image system. The CNMI relied on the power to rebate any taxes collected under the mirror-image system[4] and its power to impose additional taxes[5] so as to effectively nullify the requirement to impose the mirror-image system, declaring that all such taxes had been rebated and substituting its own system of taxation.

However, Congress interpreted the term "rebate" so as to "not permit the abatement of taxes".[6] Hence, the mirror-image system was required to be implemented and the taxes collected before they could then be rebated. The CNMI also attempted to delay the implementation of the mirror-image system within its territory.[7]

Perpetual delay, however, was not ultimately acceptable and in December 1984 the CNMI enacted legislation implementing the mirror-image system just prior to the final 1 January 1985 deadline.[8] In so doing, however, the CNMI still managed to retain its own

1. The repeal was enacted as Sec. 1271 of the U.S. Tax Reform Act of 1986, Pub. L. No. 99-514, 99th Cong., 2d Sess. (22 October 1986), 100 Stat. 2085 (TRA). The repeal, originally proposed in Chapter 15.05 of President Reagan's "Tax Proposals to the Congress for Fairness, Growth, and Simplicity", dated May 1985, at 423-431, applies to Guam, American Samoa and the Northern Mariana Islands, but not to the U.S. Virgin Islands. TRA §1271(a).

The Senate Report on the TRA (actually the Report of the Senate Committee on Finance to Accompany H.R. 3838) notes that the decision to retain the mirror-image system in the Virgin Islands was made in conjunction with "extended discussions" with representatives of the latter jurisdiction. S. Rep. No. 313, 99th Cong., 2d Sess. 479 (1986) (the "Senate Report"). The TRA does, however, include reform provisions amending the application of the I.R.C. in the U.S. Virgin Islands. See generally Turner, "Foreign Taxation Highlights of the Tax Reform Act of 1986", 21 *Int'l Law.* 487, 508-510 (Spring 1987); *Taxes Int'l*, No. 77, at 14 (March 1986). The proposed U.S. Technical Corrections Act of 1987 would clarify that the new branch-level tax will not apply to a possessions corporation (nor via the mirror-image system will any possessions branch tax be applied to U.S. corporations maintaining a branch in a territory qualifying as a possession) as from 1 January 1987. See Joint Committee on Taxation Staff Description (JCS-15-87) of Technical Corrections Act of 1987 (HR 2636, S 1350), released 15 June 1987, reprinted in *Daily Tax Rep.* (BNA) No. 115, Special Supp., at S-71–S-72 (17 June 1987).

2. Pub. L. No. 94-241, 90 Stat. 263 (1976). For a fuller description of the initial signing and subsequent ratification of the Covenant, see Liebman, Income Tax Incentives for Investment in the Northern Mariana Islands, 2 *Hawaii L. Rev.* 389 n. 1 (1980-1981) (hereinafter cited as "*Tax incentives*"). Certain other territories in the Pacific – the Federal States of Micronesia, the Republic of the Marshall Islands and Palau – are governed by separate agreements, each of which treat the respective island group as a "possession" for U.S. tax purposes. H.J. Res. 187, signed 14 Jan. 1986, noted in 73 *Stand. Fed. Tax Rep.* (CCH) – Taxes on Parade No. 6, at 3 (22 Jan. 1986). The people of Palau only recently approved the terms of their particular Compact of Free Association, *USA Today,* 24 Aug. 1987, at 6A, cols. 3-4.

3. Under the mirror-image system as applied to the CNMI, all taxes collected by the CNMI may be retained by it locally, with the exception of taxes attributable to U.S.-source income earned by an individual who ordinarily would file a return and pay taxes only to the CNMI, and who has an adjusted gross income of US$ 50,000 or more which includes at least US$ 5,000 of U.S.-source income. *Tax Incentives,* supra note 2, at 392.

4. The power of the CNMI "to rebate collections of the local territorial income tax received by it" is limited to taxes on CNMI-source income. Covenant, supra note 2, at art. VI, §602.

5. Id.

6. For a fuller discussion of the successive delays in the implementation and the interpretation of the term "rebate", see *Tax Incentives,* supra note 2, at 392 n. 13, 400 n. 73 and 403 n. 90.

7. See *Taxes Int'l* No. 36, at 40 (Oct. 1982).

8. CNMI Pub. L. No. 4-24 (1984), enacting CNMI House of Representatives Bill No. 177 ("To implement the U.S. Internal Revenue Code in mirror form as the Northern Marianas Territorial Income Tax, to repeal and re-enact Chapter 7 to Division 1 of Title 4 of the Commonwealth Code, and for other purposes").

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system of taxation. The mirror of the I.R.C. was imposed, but up to 95% of the tax was rebated.[9]

At the same time, the then-existing income tax code was maintained as a parellel system.[10] A non-refundable credit was allowed for any tax paid under the latter system against the tax due under the mirror-image system.[11] Hence, the greater of the local tax or the mirror-image tax was to be paid.

The enactment of legislation to implement the mirror-image system did not signal the end of the CNMI's fight to be allowed to maintain its own tax code without reference to the I.R.C.[12], a fight that ended successfully with the aforesaid recent repeal of the mirror-image requirement. The resistance of the CNMI is not surprising in view of the chequered history of the mirror-image system. The Senate Report on the TRA[13], for example, mentions several reasons why the mirror-image system as applied to the possessions is inappropriate.

In the first instance, the I.R.C. is a complex body of law designed to impose tax on a highly-developed economy. The I.R.C. is therefore much too cumbersome to be imposed in its entirety on small island economies. The use of the I.R.C. also limits the possession's ability to use the tax laws to pursue their own economic development policies.[14]

The Senate Report further notes that the bulk of the tax base in the possessions consists of individuals who fall within the lower tax brackets. Reducing the tax rates in these brackets, as the TRA does, can seriously reduce the amount of funds which will be generated by the mirror-image application of the I.R.C. in each such territory. Additionally, revisions to the I.R.C. designed to be revenue-neutral may not in fact impact neutrally in the possessions because of their substantively different economies. Finally, the possessions do not have the resources available to administer and enforce such a complex system, a problem greatly exacerbated by the frequent revisions to the I.R.C.[15]

The CNMI is now fully authorized to impose its own tax code[16] on (i) income from within or effectively connected with a trade or business in the CNMI; and (ii) all income of CNMI residents from whatever source.[17] However, in order to avail itself of this opportunity, the CNMI must enter into an agreement with the U.S. with respect to:

(i) the elimination of double taxation involving taxation by such possession and taxation by the United States;
(ii) the establishment of rules under which the evasion or avoidance of United States income tax shall not be permitted or facilitated by such possessions;
(iii) the exchange of information between such possessions and the United States for purposes of tax administration; and
(iv) the resolution of other problems arising in connection with the administration of the tax laws of such possession or the United States.[18]

Two additional conditions imposed in this regard are that the amount of revenue raised by any new tax scheme which is introduced by the CNMI must not be less than the inflation-adjusted amount of tax revenues raised during the last fiscal year during which the mirror-image system was in force[19], and that no tax law may discriminate against any U.S. person or resident of another possession.[20] The CNMI risks the re-imposition of the mirror-image system if it fails to comply with either of these two requirements within 90 days of the receipt of notification of any failure to comply.[21]

For U.S. tax purposes, an individual who is a bona fide CNMI resident will, with some exceptions, be considered to be a U.S. resident. However, the gross income of such individual for U.S. tax purposes will not include income derived from sources within the CNMI, or which is "effectively connected with the conduct of a trade or business by such individual" within the CNMI.[22] Any tax paid to the U.S. by a CNMI resident will be "covered over", i.e. paid to the Treasury of the CNMI.[23] Thus, the CNMI will ultimately receive the taxes due on the world-wide income

9. 4 Commonwealth Code (C.C.) §1708(a). Specifically, 95% of the first US$ 7,500,000 of tax is subject to rebate, 50% thereafter up to US$ 20,000,000 and 25% of any tax paid in excess of the latter amount.
10. See 4 C.C. §§1101-1106 & 1201.
11. 4 C.C. §1709. See also *Short Explanation of the Northern Marianas Income Tax Act of 1984,* transmitted by the Tax Task Force to the Honorable V. Sablan, Speaker, CNMI House of Representatives, under cover of CNMI Standing Committee Rep. No. 4-49, re: *House Bill No. 177,* dated 19 November 1984 (the "Short Explanation").
12. Indeed, the invitation to prospective witnesses to present comments on the legislation emphasized the opposition of the CNMI to the mirror-image system:

> It is hoped the 95% rebate will signify to the United States Government that the Commonwealth believes the mirror image I.R.C. to be a severe detriment to the economic development and welfare of the CNMI people.

Letter from Rep. J. Guerrero, Chairman of the Tax Task Force, to Invited Witnesses, re: *Northern Marianas Income Tax Act of 1984,* dated 6 November 1984.
13. Senate Report, supra note 1, at 477-479.
14. See Short Explanation, supra note 11, at 4 (concerning the separate discussion of certain "exceptional tax benefits" contained in the I.R.C. which are not beneficial to the CNMI).
15. Relief from filing requirements and tax liability was accorded for 1985 under 4 C.C.Sec. 1707 to allow taxpayers to educate themselves and the local administration to "gear up". Short Explanation, supra note 11, at 4.
16. According to TRA Sec. 1271(a):

> . . . nothing in the laws of the United States shall prevent Guam, American Samoa, or the Northern Mariana Islands from enacting tax laws (which shall apply in lieu of the mirror system) with respect to income. . . .

The CNMI is not forced to relinquish the mirror-image system. Indeed, the TRA indicates explicitly that the CNMI may elect to retain the mirror-image system. TRA §1271(f)(3).
17. TRA §1271(a)(1) & (2).
18. TRA §1271(b).
19. TRA §1271 (c).
20. TRA §1271(d).
21. TRA §1271(e)(1). The U.S. Secretary of the Treasury, having determined after consultation with the U.S. Secretary of the Interior that there is non-compliance, must so notify the Governor of the possession in question. If compliance has not occurred within 90 days, the mirror-image system shall be reinstated with effect from taxable years beginning after the date of notification, unless Congress enacts a law to the contrary. Id. The U.S. Secretary of the Treasury has discretion to waive the same-revenue-level requirement for such time as is deemed appropriate if the failure to comply therewith is for good cause and does not jeopardize the fiscal integrity of the possession. TRA §1271(e)(2).
22. I.R.C. §931(a).
23. I.R.C. §7654(a).

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of its individual residents, but the U.S. will be responsible for administering and collecting the tax payable on all non-CNMI-source income.

CNMI corporations will not be treated as foreign corporations for the purpose of the U.S. 30% withholding tax on dividends, interest, and other "fixed or determinable annual or periodic" income if (i) less than 25% of the value of the CNMI corporation's stock is owned by foreign persons; (ii) at least 65% of the corporation's gross income has been effectively connected with the conduct of a trade or business in the CNMI or the U.S. for the prior 3-year period; and (iii) no substantial part of the corporation's income is used (directly or indirectly) to satisfy obligations of persons who are not resident in the CNMI or the U.S.[24] A CNMI corporation or resident individual will *not* be considered a U.S. person for the purposes of certain U.S. reporting requirements under Subpart F with regard to CNMI corporations if at least 80% of the company's income for the previous 3-year period is derived from within the CNMI and at least 50% of the gross income during that period is generated from an active trade or business carried on in the CNMI.[25]

Now that the CNMI has been liberated from the mirror-image system, it is engaged in reviewing its own tax code with a view to enacting amendments thereto.[26] The remainder of this article will detail the existing tax system and review the recommendations offered by the Oldman Report.

THE CNMI TAX CODE

The income tax code of the CNMI is fairly simple. Individuals are subject to tax on the gross amount of their wages or salaries. The first US$ 1,000 is not subject to tax. Thereafter tax rates of between 2% and 9% are imposed, with the top rate being applicable to income in excess of US$ 50,000.[27]

Every business is subject to tax on its gross revenue at rates from between 1.5% and 5%.[28] Businesses which are engaged in agricultural production and fisheries are subject to a tax of 1% of gross revenues in excess of US$ 20,000 in lieu of the rates set out hereinabove.[29] Businesses which derive revenues from manufacturing, ocean shipping and wholesaling are taxed in the same manner as ordinary businesses, except that the maximum rate is 2%.[30] Revenue earned by such a company which does not fall within these three categories is subject to tax at the generally-applicable rates.

In lieu of the general tax rates, banks and other financial institutions are subject to tax at the greater of 5% of their net income or 2% of their gross revenue.[31]

In determining gross income, the following deductions are allowed:

- salaries;
- interest;
- rent;
- ordinary operating expenses (supplies, utility services, insurance premiums, and the like);
- loan losses;
- losses from fire, theft and similar casualties (to the extent not covered by insurance);
- bad debt reserves;
- other direct expenses (e.g. legal, advertising and auditing fees);
- losses from the sale of property; and
- depreciation.[32]

Offshore banking corporations are exempt from both the standard tax on financial institutions and the general gross revenue tax.[33]

Income derived from exports is exempt from any gross revenue tax[34] as are receipts from the sale of diesel fuel for use primarily outside of the CNMI territorial waters.[35] Foreign Sales Corporations (FSCs), as defined in I.R.C. Sec. 922, are dealt with elsewhere in the Commonwealth Code and hence are exempt from the gross revenues tax.[36] In general, FSCs are not subject to taxation by the CNMI providing certain procedural requirements are met.[37]

THE OLDMAN REPORT

As is the case with all U.S. possessions, the CNMI is in the difficult position of attempting to generate suffi-

24. TRA §1273(b)(1). The statutory withholding tax provisions of I.R.C. Sec. 1442 have been conformed. TRA §1273(b)(2).
25. TRA §1273(a).
26. Indeed, the current review is essentially a continuation of the focus by the CNMI on its taxing statutes that was begun a number of years ago. See O. Oldman, *Tax and Revenue Reform for the Commonwealth of the Northern Mariana Islands: Consultant's Revised Report to the CNMI Advisory Commission on Revenue and Taxation* (1982) (hereinafter cited as the "Oldman Report").
27. 4 C.C. Sec. 1201(a) provides that:

If the gross annual wages and salaries of an employee or other individual are:	*The tax on the gross annual wages and salaries is:*
(a) $ 0 to $ 1,000	no tax
(b) $ 2,001 to $ 5,000	2% of amount over $0
(c) $ 5,001 to $ 7,000	3% id.
(d) $ 7,001 to $15,000	4% id.
(e) $15,001 to $22,000	5% id.
(f) $22,001 to $30,000	6% id.
(g) $30,001 to $40,000	7% id.
(h) $40,001 to $50,000	8% id.
(i) $50,001 and over	9% id

28. 4 C.C. Sec. 1301 provides that:

If the gross annual gross revenue earned is between:	*The tax on the total annual gross revenue earned is:*
(a) $ 0 to $ 5,000	no tax
(b) $ 5,001 to $ 50,000	1.5% of amount over $0
(c) $ 50,001 to $100,000	2.0% id.
(d) $100,001 to $250,000	2.5% id.
(e) $250,001 to $500,000	3.0% id.
(f) $500,001 to $750,000	3.5% id.
(g) $750,001 and over	5.0% id.

See also CNMI Pub. L. No. 3-11, at §302. It appears from the statutory schedule that the flat rates apply to the entire amount of income earned during the taxable period if that amount falls within a specific bracket.
29. 4 C.C. §1302.
30. 4 C.C. §1303.
31. 4 C.C. §1304.
32. 4 C.C. §1304(b).
33. 4 C.C. §1304(d).
34. 4 C.C. §1305(a).
35. 4 C.C. §1305(b).
36. 4 C.C. §1305(c).
37. See 4 C.C. §1902(c); Short Explanation, supra note 11, at 5. An annual licence fee of US$ 500 is imposed on FSCs, however. 4 C.C. §1903. Any employees of the FSC will be subject to all applicable CNMI taxes.

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cient revenues to support the necessary governmental infrastructure so as to provide adequate services to its population (such as education and public services) as well as funding the basic needs of running the Government administration itself, all from an inadequate number of taxpayers. Historically, the U.S. possessions have relied on grants from the U.S. Federal Government to supplement locally-generated revenue in order to meet their budgetary needs. The flow of funds from such grants is, however, subject to ever-changing political currents.

Consequently, it is not only important for the CNMI to establish an effective and efficiently administered set of tax laws generating locally as much (or taking other factors into consideration, an optimal level of) revenue as is possible, but it is equally important that the tax system be seen as effective and efficient in order to (a) inspire confidence in its own taxpayers in the fairness of the system; and (b) bolster its position vis-à-vis applications for further U.S. grants that it has truly exhausted local sources of income.[38] To this end, the CNMI commissioned the Oldman Report on "tax and revenue reform" in 1981 as a step in reviewing its current system of taxation and with a view toward generating recommendations for the future.

In brief, the Oldman Report recommends a net income tax system on the grounds that such is "widely regarded as the fairest form of tax".[39] A broad base tax allows for the imposition of more modest rates which, in turn, have less of a distorting impact on employment and investment incentives. Most but not all U.S. States impose a net income tax on individual residents as well as the local-source income of non-residents, generally in those situations where the non-resident has some type of presence in the State, for instance a branch or office.

Some U.S. states which do not impose a net income tax have another source of tax based on a local industry peculiar to the state. For example, in Florida, where tourism is very strong, a tax is imposed on the rental of hotel space. Texas, which has rich oil and natural gas deposits, taxes heaviest industries which exploit that state's natural resources.

Even presuming the CNMI was in a position to capitalize on the exploitation of its own resources or tourism, the wisdom of following the lead of a minority rather than a majority of U.S. states is viewed as questionable by Professor Oldman. As noted above, unlike residents of any particular U.S. state, CNMI residents will not be subject to Federal taxation on their income. Consequently, if the CNMI wishes to be in the most favourable position for requesting assistance (such as financing or Federal services as well as grants-in-aid), it must establish a system which requires each income-generating person to contribute a reasonable amount to the financing of local administration and services. For these additional reasons, the imposition of a net income tax on individuals is viewed as advisable.[40]

The Oldman Report recommends a flat tax on net income at one rate for individuals and possibly another rate for corporations. The primary advantages of a low flat rate of taxation on a broadly-based definition of income have been previously discussed. A further advantage is that such a system is simpler to interpret and easier to administer.

The complexity of the I.R.C. has been greatly compounded by the tendency to use the tax system to further social or economic goals. For instance, provisions designed to encourage capital investment such as the investment tax credit and accelerated rates of depreciation gave rise to a myriad of regulations necessary to interpret and apply such statutory provisions. Once this process is begun, the tax base begins to erode for reasons unrelated to determining a reasonable definition of net income.

Not only does such a tax system give rise to hidden subsidies[41] and added complexity, but rates must then be raised to maintain the same revenue levels for a given amount of gross income. The more recent trend away from the non-fiscal use of a taxing statute (in order to avoid the problems inherent in any system not embodying pure fiscal measures) is partly reflected in the TRA which broadens the tax base and flattens and lowers the applicable tax rates. It would be to the CNMI's benefit to avoid this inevitable tendency toward complexity from the beginning by providing few deductions and low tax rates.

The Oldman Report continues by detailing various suggestions with regard to the specific rate structure which might be imposed in the CNMI as well as the inter-relationship between taxes on income and excise taxes as well as miscellaneous revenue measures, such as property taxes and licence fees. These are too complex and detailed for purposes of this discussion. In addition, his Report discusses certain issues relating to tax administration.

One issue which is particularly interesting relates to Professor Oldman's discussion of social, economic and political developments.[42] One of the authors of the present article had already discussed the disadvantages of the CNMI becoming an "enclave" economy and

38. As the Oldman Report points out, the Reagan Administration has been engaged in seeking to shift more of the burden for providing services from the Federal Government to the states. Oldman Report, supra note 26, at 9. This trend may not augur well for U.S. possessions.
39. Id. at 6.
40. Even before the TRA, the Carter Administration had favoured scrapping the mirror-image system, but had instead sought to replace it by the full imposition of the I.R.C. administered locally in the possessions directly by the U.S. Internal Revenue Service. The Oldman Report notes that this idea presumes that the Federal services to be supplied in these territories would be the same as those supplied in the U.S. states. Id. at 8.
Obviously, the establishment of a local tax code which is designed specifically for the CNMI and which is locally administered is based on the view that public services in the CNMI will primarily be provided for and funded locally. This leaves open the question of what funding and services the U.S. Federal Government will provide.
41. The U.S. finally tackled the hidden subsidy issue by the annual compilation of a tax expenditure budget which calculates and reports on the amount of revenues foregone through the various tax incentives provided in the I.R.C.
42. Oldman Report, supra note 26, at 36-37.

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had recommended that the local government eschew any tendency toward becoming a tax haven.[43] This aspect is not discussed in the Oldman Report, but the recent developments surrounding the tax status of Mr. W. Millard – who had expatriated to the CNMI allegedly to (in part) avoid tax on the sale of his shares of stock in Computerland – only further highlights the disadvantages in this day and age of establishing a tax-haven identity.[44]

CONCLUSIONS

The enactment of TRA marks a significant step forward in terms of the development of a manageable system of taxation for the CNMI as well as for other U.S. possessions. The CNMI must now rise to the challenge of developing its own coherent tax statutes, which will provide for fairness as well as administrative ease, raise sufficient tax revenues to support the economy while encouraging investment and allow for such other incentives as may prove necessary and advisable to encourage planned and stable growth and development.[45]

43. Tax incentives, supra note 2, at 414-422.
44. See, e.g., Wells, Pacific Glitches: A Computer Tycoon and Saipan Discover they are Incompatible, *Wall St. J.*, 29 June 1987, at 1, 11.
45. It is interesting to note that the U.S. Internal Revenue Service recently issued a Revenue Ruling indicating that the Commonwealth of the Northern Mariana Islands would qualify as a geographic area in which expenses incurred by persons attending conventions, seminars or similar meetings there can be claimed as business expense deductions under I.R.C. Sec. 274(h). Rev. Rul. 87-95, 1987-38 IRB – (dated 21 September 1987), reprinted in *Daily Tax Rep.* (BNA) No. 181, at H-1 (21 September 1987). It is not necessarily clear, however, whether the CNMI can indeed effectively attract such convention-oriented and tourist business in view of its location.

[continued from page 547]

voted before year-end it will be very difficult to implement it before 1989 (1988 taxable income).

In this section we shall focus on the taxation of expatriates in Morocco.

Expatriates in Morocco do not benefit from any favourable treatment and, given their level of remuneration, are rather heavily taxed.

Salaried employees resident in Morocco are subject to tax, excluding any tax agreements, on their entire income. Non-residents are taxed on the income earned from Moroccan sources. The tax agreements signed by Morocco rely on the definition of residence given in the OECD Model Agreement and allocate the taxing of wages and salaries to the country where the activity is exercised, subject to application of the temporary assignment clause.

Thus, a salaried employee assigned to Morocco will have the additional contribution for income earned by natural persons and the contribution to national solidarity deducted from his wages and salary. This deduction is progressive (by brackets from 0 to 60%) and is applied to net income, i.e. after deduction of pension and social security contributions, a 10% deduction for professional expenses (20,000 DH ceiling) and family related deductions (1,200 DH per child, 2,400 DH for a non-working spouse).

The additional contribution on the income of natural persons is a progressive tax (by brackets from 0 to 45%) determined in accordance with the net overall income of each taxpayer, i.e. after certain deductions including a 25% deduction. The national solidarity contribution is also a progressive tax calculated per working day. The taxable base is that used to calculate deductions from wages and salaries after certain adjustments which reduce this taxable base.

The general income tax system currently being discussed will replace for employees these three types of tax with a single tax applicable to all income received by natural persons and should not increase the tax burden.

For non-employees most taxes that they presently pay (IBP (impôt sur les bénéfices professionnels), urban tax on rental income, investment reserve) will be replaced by the general individual income tax (IGR or impôt général sur le revenu).

This reform will probably increase their tax burden due to the fact that a certain number of deductions will no longer be allowed.

The Moroccan Government's goal regarding these tax reforms is ambitious. Nevertheless we can assume that it will be reached and will contribute in an efficient way to the economic development of this country.

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VIET-NAM:

Changes in the Tax System *

By Prof. Dr. Tibor Nagy

On the basis of the resolutions of the Fifth Congress of the Viet-Namese Communist Party,[1] the Viet-Namese Government has modified its tax system with the aim of developing the national economy, to strengthen its socialist sector and to improve the conditions for production.[2] The present tax system consists of the following kind of taxes.

I. STATE ENTERPRISES TAXATION

A. The *turnover tax* which is included in the selling price. In fact it is the difference between the production price and the selling price as established by the Government and it must be paid over by the *State trade enterprises and trade organs* to the State Treasury. (This is similar to the traditional Soviet tax system.)[3]

B. Fifty percent of the profits of production financed *by State means* is placed at the disposal of the State enterprises, while the other 50% will be paid over to the local or State Treasury.

Seventy to eighty percent of the profits of production *financed by own means* remains at the disposal of the enterprises and the remainder will be paid into the State Treasury.

C. The amounts paid into so-called enterprise funds (such as the production development fund, socio-cultural fund, wage fund and interest fund[4]) are not taxed. But if the total of the interest fund exceeds with 30% the wage fund (i.e. the annual total of salaries paid) a tax with progressive rates is to be paid to the State Treasury (this tax is tantamount to a tax on payroll imposed on the enterprise).

II. TAXATION OF THE COOPERATIVE AND PRIVATE SECTOR

In the cooperative and private sector the agricultural tax and the trade and industrial taxes are the most important obligatory payments regulated by the Decrees of the State Council of 1983[5] which are also in force in 1986/87.

Professor Dr. Tibor Nagy was born in Budapest in 1924. He obtained a doctorate in politics at the University of Budapest in 1946 and a doctorate in law a year later. In 1949, he became ministerial secretary in the Supreme Economic Council, and in the year after, deputy chief of the financial department in the Ministry of Education. In 1961, he was awarded the scientific degree "candidate" by the Hungarian Academy of Sciences and, in the same year, was appointed associate professor in the Faculty of Law and Political Sciences at Budapest University, where, in 1969, he became professor and head of the Department of Financial Law. In 1983, Professor Nagy became a visiting professor at Hamburg University.

Professor Nagy studied public finance and financial law with research fellowships in the U.S.S.R. (1957), the German Democratic Republic (1959) and Poland (1960). During 1968-1969, he was a Ford Fellow at Harvard and Columbia Universities. He is the author of books and articles on financial law, international financial (tax) law, financial systems and law of the socialist economic integration and the history of Hungarian State finances. Since 1961, he has published 40 works in Hungarian and 43 in other languages.

Professor Nagy is a member of the Institut International de Finances Publiques and the World Association for International Relations.

* A short summary of the tax system on the basis of an article entitled "The financial and credit system of the Viet-Namese Socialist Republic" by Chu Tam Thu'c, former Minister of Finance, was published in *Pènzügyi Szemle* (Financial Journal) No. 11 (1986) (Budapest) at 868-873. This summary was prepared and further completed by Prof. Dr. T. Nagy, Budapest (Hungary).

1. March 1982.
2. Reform of the tax system should serve to decrease inflation which has a monthly rate of 70-80% and the deficit of the 1987 Budget (presently at 12 billion dong = US$ 150 million). The inflation rate for 1986 was 400%. The U.S.S.R. has promised to give Viet-Nam a subsidy of between US$ 11.7–13.2 billion for 1986-1990. The total foreign debt of Viet-Nam is US$ 8.1 billion (see: *Világgazdaság* (World Economy) No. 18 April 1987, 9 May 1987, 23 June 1987, and 19 August 1987).
3. See *Guides to European Taxation: Volume V, Taxation in European Socialist Countries*, Chapter Union of Soviet Socialist Republics, in particular Sec. 6.
4. The term "fund" denotes amounts which are budgeted for certain purposes.
5. The State Council is, since 1980, as the collective Presidency, the highest organ of the National Assembly and constitutes the Presidium of the Viet-Namese Republic.

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A. The *agricultural tax* is imposed on (a) agricultural cooperatives, independent production groups (these are similar to the cooperatives), social and other institutions, military units, as well as members of cooperatives, workers and employees possessing "house hold plots" (i.e. small plots of land adjacent to their homes) or who are growing agricultural products on their farms and (b) individual private farmers and such kinds of agricultural production groups whose members are not members of cooperatives.

The group of taxpayers described under (a) receives privileged tax treatment in that they pay only the regular basic rates of agricultural tax. Taxpayers falling under category (b) are subject to an additional *surtax* whose rate is established annually as a function of the size of the cultivated area. State farms and agricultural machine stations are not subject to these taxes, since they must deliver all their products to the State and pay any revenue they receive to the State Treasury. According to the decisions of the Plenum of the Viet-Namese Communist Party of April 1987, the future fiscal policy should guarantee the farmers a 40% profit upon selling their agricultural products to State trade agencies by introducing new agricultural taxes and by having the State pay higher purchasing prices.[6]

B. By virtue of the Decree of 1983 promulgated by the State Council on the assessment of the trade and industrial taxes, the following taxes are to be paid:[7]

(a) Tax on receipts, paid by smallholders on *any* income of their activities. Tax rates are:
- 3, 4 or 5% in the *production sector,*
- 5, 7 or 9% in the *service sector,*
- 6, 8 or 10% in the *municipal food sector.*

The effective tax rates are a function of the kind and volume of the transactions.

(b) *Profits tax* is paid by *private* organizations and private persons (at progressive rates). However, cooperatives pay tax at lower rates ranging from 5-20%.
In some sectors in addition to the profits tax a *"supplementary tax"* is imposed (e.g. on cooperatives rendering services to production units including transportation services if their profits exceed a sum fixed by Decree).
On certain economic activities a 10% *surtax* is levied with the aim *to discourage* these activities.
Incomes derived from the illegal increase of prices or speculation gains are subject to tax at steeply progressive rates, the maximum rate going up to 100%.

(c) *A one-time trade tax* is levied on organizations and private persons on their receipts of any *occasional* trade activity.

(d) *"Patent tax":* which is a tax on industrial royalties to be paid by all tax subjects.

The aim of the Viet-Namese fiscal policy is to *decrease* the importance of taxes and to *strengthen* the State-sector. But there is a special situation: in the Southern part of the country (i.e. formerly designated as South Viet-Nam) the economic system is still very differentiated so that in this part of the country it is very important to implement an appropriate tax policy. Note that in this part of the country 5 types of economic "spheres" have been established.

Taxes are sources of revenue for the central State Treasury but the local[8] treasuries receive a share from the total yield of the:
- turnover tax;
- agricultural tax;
- trade and industrial taxes; and
- profits of the local State enterprises.

The rates of sharing are differentiated and are fixed for *2 years. Grants-in-aid* complete the tax sharing revenues of the local budgets. If the local revenues exceed the planned total, 30-50% of the excess remains in the local treasury and the difference must be paid over to the State Treasury.

The Sixth Congress of the Viet-Namese Communist Party which was held in September 1986 adopted a resolution stating that there was an urgent need to change the price, tax, credit and wage legislation to stimulate the economic activities of enterprises, workers, craftsmen and farmers. These changes may possibly become law in the 1987-88 financial year.[9]

On the basis of the Party Resolutions, the City Council of Hanoi issued a decree on the taxation of enterprises of the private sector carried on by households or families and comprising small industrial businesses as well as handicraft industry. These private enterprises are tax-exempt if their proprietors:
- have their main employment elsewhere; or
- receive an old age benefit which they supplement by the income from the enterprise; or
- run the business exclusively with members of their family which means that in this case they may not employ other persons; or
- start a new enterprise on or after 1 January 1987 (this exemption is given for one year only). For enterprises which have been created before 1 January 1987 they may request a tax exemption or tax deferral.

As of December 1986 members of cooperatives may relinquish their membership provided that they can show that they have valid reasons to do so. Such persons may start private economic activities but they may not benefit from any tax exemptions or allowances.

6. *Világgazdaság* No. 75 of 1987 (18 April 1987).
7. The aim of the State Council by imposing these taxes is to increase the production in the private sector and to mobilize the savings in this sector. Taxes are thus used to control the commercial and industrial activity in the private sector and to accelerate the socialist reorganization of private trade.
8. On the basis of the new Constitution adopted in December 1986 Viet-Nam is divided into 36 provinces and one special area directly under the control of the Central Government, and subdivided into districts, towns and villages.
9. *Nemzetközi Szemle* (International Review), No. 1 of 1987 at 6.

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Producers selling their products on the market are subject to turnover tax and trade tax.

The above provisions, however, have only force of law in the Hanoi area. For instance, producers selling their products in the market outside Hanoi are subject to the trade tax and the tax on receipts.

III. NEW JOINT VENTURE LAW

It has been reported that a new joint venture law will be approved by the Viet-Namese Government in 1987. The foreign partner of such a joint venture will be required to have a minimum share capital of 25%. Under the 1977 Regulations on foreign investments in Viet-Nam, which are currently in force, this percentage is 30%. There will be no 49% maximum limit as under the 1977 Regulations, meaning that fully foreign-owned companies may operate in Viet-Nam.

The duration of a joint venture will be 20 years (now 10 to 15 years), but the venture can be extended in some cases. Foreigners may be permitted to act as directors of such joint ventures.

Should the Viet-Namese Government decide to nationalize a joint venture in a case where exceptional national interests are at stake, an appropriate compensation will be given (this is also the case under present law).

Joint ventures will be exempt from tax in the first two years of business and be eligible for a 50% reduction in the following two years (under current law the exemption period is stated in the joint venture contract and varies depending on the activity, the location and the capital invested). When they become taxable, joint ventures will be subject to a *tax on turnover* with rates between 20% and 25%.

In addition, a *profits tax* will be imposed at an average rate of 25%. Transfer of profits into the home-country of a joint venture partner will be allowed only if they receive hard currency from their activities. The tax rate will be 20% when exporting in large amounts into hard currency States; involved in activities which are labour intensive; using new technology; utilizing natural resources of Viet-Nam; or receiving hard currency for service activities.[10] Reinvested profits will be subject to a lower rate of 10%.[11] Currently income tax rates depend on the kind of business operation: 30% for export production; 40% for large capital investments and high technology investment; 50% for others. Furthermore, it is proposed that 5% of the profits must be transferred to a reserve fund.[12]

10. *Világgazdaság* (19 August 1987).
11. Ibid.
12. *Tax News Service* (1987) at 93-94.

Conference Diary

DECEMBER 1987

Pensioen-constructies. Amsterdam, 2 December (Dutch):
Euroforum, Antwoordnummer 27, 5600 VB Eindhoven, The Netherlands.

Internationale interne verrekenprijzen. Amsterdam, 3 December (Dutch):
Euroforum, Antwoordnummer 27, 5600 VB Eindhoven, The Netherlands.

Die Steuerreform 1990. Bonn, 3 December (German):
FORUM-Institut für Management GmbH, Husarenstrasse 1, Postfach 105060. D-6900 Heidelberg, Federal Republic of Germany.

Taxation of Branches and Subsidiaries. Brussels, 3-4 December (English):
Management Centre Europe, Postbus 95, NL - 3417 ZH Montfoort, The Netherlands.

Hamburger Tagung zur internationalen Besteuerung. Hamburg, 4 December (German):
Institut für Ausländisches und Internationales Finanz- und Steuerwesen, Grindelhof 38, 2000 Hamburg 13, Fed. Rep. of Germany.

Systematische Darstellung des deutschen Aussensteuerrechts und des Rechts der Doppelbesteuerungsabkommen anhand praktischer Fälle. Bad Homburg, 7-8 December (German):
Deutsche Anwaltsinstitut e.V., Fachinstitut für Steuerrecht, Postfach 101109, 4630 Bochum 1, Fed. Rep. of Germany.

Fundamental elements of U.S. Federal Taxation. Lésigny, 7-12 December (French):
The American Tax Institute in Europe, 14, rue Jean Mermoz, 75008 Paris, France.

A Workshop on Treaty Shopping. London, 10 December (English):
British Branch of I.F.A., Att. Mr. Eric Tomsett, Touche Ross & Co., Hill House, 1 Little New Street, London WC4A 3TR, United Kingdom.

Belgisch Fiscaal Recht. Antwerpen, 10-11 December (Dutch):
Kluwer Seminars, Antwoordnummer 424, 7400 VB Deventer, The Netherlands.

JANUARY 1988

Fundamental elements of the U.S. Federal Taxation, Bougival, 11-16 January (English):
The American Tax Institute in Europe, 14, rue Jean Mermoz, 75008 Paris, France.

U.S. Corporate Taxation: advanced subjects. 11-16 January (English):
The American Tax Institute in Europe, 14, rue Jean Mermoz, 75008 Paris, France.

The multilateral exchange of information and assistance in tax administration. London, 25 January (English):
British Branch of IFA, Att. Mr. Eric Tomsett, Touche Ross & Co., Hill House, 1 Little New Street, London WC4A 3TR, United Kingdom.

Uitzending van personeel. Amsterdam, 25 January (Dutch):
Euroforum, Antwoordnummer 27, 5600 VB Eindhoven, The Netherlands.

FEBRUARY 1987

First South Asia Regional Conference, New Delhi, 18-20 February (English):
Indian Branch of IFA, Att.: Mr. D.P. Vaish, Flat 7, 10 Hailey Road, New Delhi 110001, India.

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THAILAND:

Taxation of Joint Ventures

By Montri Hongskrailers

Author's note:

If an enterprise is carried on jointly between an individual and another individual, or between an ordinary partnership and another ordinary partnership, or between an association or foundation and another association or foundation, it is not a Joint Venture. It is merely an ordinary partnership. As such, income tax must be paid by the individual person or by the ordinary partnerships if profits are made. After the distribution of profits, an individual who receives such profits is exempt from paying additional income tax.

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.

GENERAL MEANING OF A JOINT VENTURE

A Joint Venture is a business undertaking by two or more parties in which profits, losses and control are shared. A Canadian law dictionary states that though the term is considered synonymous with a partnership, a Joint Venture may connote an enterprise of a more limited scope and duration, though there is the same sort of mutual liability.

From the above definition, we may gather that the characteristics of a Joint Venture are:

- a business undertaking by two or more parties;
- profits, losses and control are shared among the parties;
- an enterprise of a limited scope and duration;
- mutual responsibility is shared among partners or participants.

These characteristics also serve as the Revenue Department's guideline for interpretation of a Joint Venture; this will be discussed later.

A JOINT VENTURE DEFINED (BY THE REVENUE CODE)

The term "Joint Venture" is defined by the Revenue Code as a business or profit seeking enterprise carried on jointly by:

- a company and another company, a company and a juristic partnership, a juristic partnership and another juristic partnership;
- a company and an individual, a non-juristic body of persons, an ordinary partnership or another juristic person;
- a juristic partnership and an individual, a non-juristic body of persons, an ordinary partnership or another juristic person;
- a company and a juristic partnership, an individual, a non-juristic body of persons, an ordinary partnership or another juristic person.

LEGAL IDENTITY OF A JOINT VENTURE

A Joint Venture is not a legal entity, but it is a tax entity as if it were a juristic company or partnership. It is therefore subject to corporate income tax and other taxes, as provided by the Revenue Code.

Although it is not a legal entity, the partners of a Joint Venture are viewed as branches of their head office, regarding the project for which the Joint Venture is formed. If a Joint Venture partner is a juristic company or partnership registered under foreign law and does business in compliance with the Alien Business Law (NEC Announcement No. 281), that partner must apply for and obtain an Alien Business Permit.

RESTRAINTS UPON A NON-JURISTIC PERSON UNDER THE CIVIL AND COMMERCIAL CODE

A Joint Venture cannot make a contract or buy and sell under its own name.

A Joint Venture cannot be a plaintiff or a defendant in Court. Therefore, when it is a matter of money lending or buying/selling as well as paying wages, such must be done by one of the individual partners (or both) on behalf of the Joint Venture. The account should be clearly separate from the individual accounts of the Joint Venture partners. Otherwise, it may be mixed up with the Joint Venture partners' accounts which may cause trouble in the tax management of the Joint Venture as well as in their individual accounts.

INTERPRETATIONS OF A JOINT VENTURE BY THE REVENUE

Before the inclusion of the term "Joint Venture" in the Revenue Code on 31 December 1978 (2521), the Rev-

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enue Department collected tax from a joint operation by having the Joint Venture compute profits from its work. When the profit figures were obtained and after paying tax thereon, the Joint Venture distributed the said profits to its partners in proportion to each partner's investment, the partners then paid tax from their share of profits in accordance with their status, e.g. if a joint operation partner was a company, the corporate income tax would be imposed, and if it was an individual, a personal income tax was applicable.

After 31 December 1978 (2521), the Revenue Code was changed and the term "Joint Venture" was added as part of a juristic company or partnership. This change recognized the tax status of a Joint Venture as that of a company. This was in order to avoid any argument as to whether a Joint Venture should be taxed as an individual or as a company or whether a Joint Venture was not a taxable entity.

When the "Joint Venture" was recognized by the Revenue Department, it originally held the interpretation that, if two or more Joint Venture partners undertook any work for any employer under the same contract, it constituted a Joint Venture. It did not seem to matter whether each partner undertook such work with a view to share the profit or loss, or if contractually the partners were responsible separately and payment to each was made separately in accordance therewith.

A new Revenue Department interpretation was made around February 1983 (2526). It was to the effect that, to be a Joint Venture, the intention of the partners of the Joint Venture must be to seek joint profits by such a venture. The mere joint signing of the same contract and working together with separate responsibilities were not the criteria constituting such a Joint Venture. The Revenue Department also made a broader interpretation of a Joint Venture: that it should carry on a temporary work or project as partners making a joint investment with the aim at sharing profits and losses among them. However, as the law does not specifically mention the word "temporary", this criterion was later dropped.

A recent rumour, however, has it that the Revenue Department is going to honour the old interpretation of a Joint Venture again. That is, if collaborators sign the same contract, it would constitute a Joint Venture.

REGISTRATION REQUIREMENT

Corporate and business tax numbers: As a Joint Venture is considered a juristic company or partnership under the Revenue Code, a Joint Venture is subject to corporate income tax. Therefore, a Joint Venture has to obtain a taxpayer's ID card and number. Also, if a Joint Venture carries on a business which is subject to business tax, it must apply for a business tax number within 30 days from the date the operation started and pay monthly business tax thereon within 15 days of the following month.

Alien Business Permit: As mentioned above (see "Legal identity of a Joint Venture"), if a Joint Venture partner is a juristic company or partnership registered under foreign law and does business which is under control by the alien business law in the category which may be permissible to be carried on in Thailand, that partner must apply for and obtain an Alien Business Permit from the Director General of the Commercial Registration Department of the Ministry of Commerce.

THE COMPUTATION OF JOINT VENTURE TAXES

Accounting periods: In computing income tax, a Joint Venture must set its accounting period similar to that of any juristic person, under Section 65 of the Revenue Code. An accounting period must be 12 months (with some exceptions) from the date the business operation commences.

Conditions for computing net profits and tax rates: In computing the net profits of a Joint Venture, the conditions of Sections 65 bis and 65 ter of the Revenue Code are to be applied. The rate of tax is 35% of the net profit, the same as for other juristic entities.

Paying tax twice yearly: In addition, a Joint Venture must pay tax twice yearly. This is similar to other juristic persons. The Joint Venture must prepare an estimate of net profits or net losses arising from or in consequence of the business carried on or to be carried on during an accounting period. A tax return must be filed and paid within 2 months, from the last day of the period of 6 months, counting from the first day of the accounting period.

Filing of the audited balance sheet and profit/loss account: As a juristic company or partnership, a Joint Venture has to file a balance sheet and a profit and loss account under Section 68 bis of the Revenue Code and the said statements must be audited by an auditor in compliance with Section 69 of the Revenue Code.

Withholding taxes: If the payer of income to a Joint Venture is a government agency, the said agency must withhold tax at source at the rate of 1% under Section 69 bis of the Revenue Code. However, if the work done by the Joint Venture is "hire-of-work" under category 4 of the Business Tax Schedule of the Revenue Code and the employer is a government agency, the said agency must withhold tax at source at the rate of 3.3%.

EXCHANGE GAIN AND LOSS

Unrealized profit: If the Joint Venture partners are juristic companies or partnerships registered under foreign law, they normally keep accounts in foreign currency at their head offices abroad. When said accounts are re-prepared in Thailand, there may be a problem of exchange gain. As with any company this can cause a Joint Venture to suffer payment of additional taxes on this unrealized gain.

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Conversion problem: Another problem on currency matters is in the exchange of currency. If the transactions occur frequently, there will be a lot of conversion work to be done on the part of accountants.

JOINT VENTURE EXPENSES

The Joint Venture expenses in its books of account can be structured by 3 methods, as follows:

"Expenses passed on" method: The expenses incurred in the books of account of a Joint Venture partner can be broken down into two categories: "direct expenses" and "indirect expenses". It is no problem for the head office to charge the direct expenses to its branch; the branch then passes those expenses on to the books of account of the Joint Venture.

However, it may be more difficult for the Joint Venture to charge the indirect expenses in the same way as that of the direct expenses. According to the new rules, stated in the Revenue Department's Order, No. 13/1986, as amended by Order No. 14/1986, dated 30 June 1986, the general administrative expenses of an overseas head office and its branches which were expended partially by its Thai branch are allocated based on the following rules and methods:

(1) The head office expenses charged to a Thai branch are to be allocated upon the generally accepted principles of fairness, consistency and in accordance with the same method as those applied to other branches. The computation is to be as follows:

Project Income[1] × Head Office Expense = Acceptable Expense Worldwide Head Office Income

The acceptable expenses so calculated represent a fair share which has been expended for the purpose of business in Thailand under Section 65 ter (14) of Thai Revenue Code.
The allocated amount of the acceptable expenses must not have been deducted as expenses by the head office or by any branch for the computation of net profits.

(2) The total administrative and management expenses of the head office have already been deducted through the office rental, charges of electricity and water supply, costs of office supplies, utensils, depreciation of office equipment and furniture.
The expenses, thus, do not include any research and development expenses.

(3) The allocation is for a project of a Joint Venture in Thailand.

The statements of (1) through (3) must be signed by the head office's auditor.

However, there is a chance that the Revenue Department may not allow the indirect expenses to be booked in the Joint Venture's account, if, in its opinion, it is contrary to Section 65 ter (13) and (14) of the Revenue Code, which states:

(13) Any expenses not exclusively expended for the purpose of acquiring profits or for the purpose of business, (are not allowable).

(14) Any expenses not exclusively expended for the purpose of business in Thailand, (are not allowable).

"Invoicing" method: The expenses incurred in the books of account of the head office for the Joint Venture can also be invoiced to the Joint Venture's books of account. However, if invoiced by the head office, and charged as "Royalty Expenses", the head office invoices may be subject to withholding tax at the rate of 25%.

If the Joint Venture has no records to prove its expenses, the expenses are generally allowed, as follows:

(1) In the case of carrying on a business of "contract of work", expenses are allowed at the rate of 70% of gross income before deduction of any expenses incurred in the accounting period; this is similar to the rate of standard deductions allowed in Section 7 of Royal Decree (11) B.E. 2503 (1960).

(2) In the case of carrying on a business of "purchasing and selling goods", expenses shall be allowed at the rate of 80% of the gross income before deduction of any expenses incurred in the accounting period; this is similar to the rate of standard deductions allowed in Section 8 (25) of the Royal Decree (11) B.E. 2502 (1959).

GENERAL VIEW OF A JOINT VENTURE AND THE TAXATION OF ITS PARTNERS' INCOME

Prior to 1980, the tax on a Joint Venture and its partners was collected in 3 steps as follows:

(1) collected from the Joint Venture itself (40% (old rate) of the net profit);

(2) if said Joint Venture partner was a listed company, there was no tax. If not, half of the share of profit was subject to another (40%) tax (old rate);

(3) collected from the share of profit remitted out of Thailand. In the case where a Joint Venture partner was a juristic company or partnership, and if:
   (a) said partner carried on a business in Thailand, a share of profits was subject to corporate tax and if the remaining share of profits was remitted abroad, the remittance tax of 25% (old rate) of the remitted profit was imposed;
   (b) said partner did not carry on a business in Thailand, the share of profits was income under Section 40(4)(b) of the Revenue Code; the remitted share of profits was subject to a remittance tax at the rate of 25% (old rate) of the amount remitted.

At present, the taxes on a Joint Venture and its partners, are collected in 2 steps, as follows:

(1) The Joint Venture has to pay corporate income tax at the rate of 35% of net profits.

(2) The Joint Venture partners have to pay tax as follows:

1. Income derived from the project for which the Joint Venture was created.

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(a) If the partners are:
   (i) juristic companies and partnerships organized under Thai law,
   (ii) juristic companies and partnerships organized under foreign law and carrying on business in Thailand,

   no income tax is due on that part of assessable income that consists of dividends or profit shares derived from a Joint Venture carrying on business in Thailand under Section 5 bis of Royal Decree 10/1957 (2500).

(b) However, if the juristic company or partnership organized under foreign law has received a share of profits remitted from Thailand, a profit remittance tax of 20% of the amount received will be applied.

SOME QUESTIONS CONCERNING A JOINT VENTURE'S TAX

Question: Can a Joint Venture's first year's loss be allocated to a Joint Venture's partner and be treated as an expense of a Joint Venture's partner in that year?

Answer: By comparing it to a company the shares of which are held by another company, we can see that when that company makes a loss, said loss cannot be allocated to its shareholders to be treated as their expense. A loss can only be set in the books of account of that company and be carried forward to be deducted from its profit in the subsequent year. This concept applies also to a Joint Venture. Because a Joint Venture is a company, a loss incurred in the first year has to be carried forward to be deducted from the profit in the subsequent year, in accordance with Section 65 ter (12) of the Revenue Code. However, when a Joint Venture has finished its project or has been dissolved, a loss by the Joint Venture can be allocated to each partner of the Joint Venture proportionately.

Question: How is the investment in a Joint Venture treated on the books of account of the Joint Venture partners?

Answer: This case is similar to the case where a company buys shares of another company. This investment is considered as a company asset, but it is not a depreciable asset. Therefore, the investment in a Joint Venture is not depreciable on the books of account of a partner in a Joint Venture.

Question: How to dissolve a Joint Venture?

Answer: The Revenue Code has no provision to deal with this matter. Therefore, Section 72 of the Revenue Code should be applied to this situation. This Section provides for the dissolution of a juristic company or partnership. The liquidator and the manager of said entity must notify the assessment officer within 15 days from the date when the registration of dissolution is recorded by the appropriate authority. If said persons fail to comply therewith, the assessment officer may require the juristic company or partnership to pay, in addition to the tax payable, a surcharge equal to the amount of the tax. Such surcharge is regarded as tax.

If there is a tax to be paid, the liquidator and the manager are jointly responsible to ensure that the tax is paid.

Question: If two foreign companies, having jointly invested money, accept work for a principal in Thailand, are the said companies considered to be doing business in Thailand?

For example, Company A and Company B are registered under foreign law and do business in a foreign country and neither has any branch in Thailand. They invest in Thailand in the form of a Joint Venture to bid for construction work with a Thai government agency. Company A invests 60% and Company B invests 40%, are Company A and Company B deemed to be doing business in Thailand?

Answer: The Revenue Department considers that neither Company A nor Company B is doing business in Thailand. The profit of a Joint Venture shall be subject to corporate income tax at the rate of 35% of the net profit. The profit remitted from a Joint Venture to Company A and Company B will be subject to withholding tax of 20% of the profit remitted under Section 70 of the Revenue Code. In case an individual is a Joint Venture partner, the profit received from the Joint Venture will be subject to withholding tax at the rate of personal income tax. However, a tax credit under Section 47 bis of the Revenue Code of 30% on the dividends or share of profits received by said individual is also applied.

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ISRAEL:

The 1987 Tax Reform

By Prof. Arye Lapidoth

The 1987 Tax Reform mainly aims at reducing the income tax rates of both individuals and corporations.[1] The new corporation tax rates apply as of 1 January 1987; those relating to individuals apply as of 1 April 1987.[2]

BEFORE 1987

Prior to the Reform, the maximum marginal rate of income tax imposed on individuals was 60%. As far as corporations were concerned (i.e. companies and other "body corporates"), the effective rate of tax imposed on undistributed profits was 61%. That figure was arrived at as follows: The corporation paid 40% "corporation tax" on its undistributed profits. In addition, it paid 35% income tax. In computing the amount of income subject to income tax, the amount of corporation tax was deductible. Hence, if the corporation had a profit of 100, it paid 40 corporation tax as well as 35% income tax on 60 (100 – 40), i.e. 21. The effective aggregate rate of corporation and income tax on undistributed profits was thus 61% (40 + 21).

Where the profits were distributed, the effective rate of tax imposed on the dividend, the corporation and the shareholders receiving the dividend, could amount to 67%.

In order to understand how that figure was reached we have to bear in mind that the dividend was subject to a maximum marginal income tax rate of 45%. The dividend (paid by an Israeli corporation) is also deductible in computation of the amount of income subject to income tax.

Suppose a corporation having a profit of 100 decided to distribute all its profits as dividends. Suppose also that the shareholders receiving the dividend had to pay 45% income tax on the dividend. The corporation would first pay 40 corporation tax. The remaining 60 would be distributed as dividends and taxable in the hands of the shareholders in the amount of 27 (45% of 60).

The effective aggregate amount of tax paid on the distributed profits would thus be 67% (40 + 27). (No income tax would be paid by the corporation because both corporation tax (40) and the paid dividends (60) would be deducted in computing the income subject to income tax payable by the corporation (100 – (40 + 60) = 0).)

It should be pointed out that the rates of tax which have been stated and explained above applied only to "regular corporations". On the other hand, "industrial corporations" and corporations having an "approved enterprise", enjoyed special statutory tax benefits. The tax benefits were given by a special law aimed at encouraging industry as well as a special law for the encouragement of capital investment.

THE 1987 TAX REFORM

Having outlined the tax rates structure under the law prior to the 1987 Tax Reform, the main features of the Reform may now be fairly briefly considered.

Individual income tax rates

The maximum marginal tax rate has been reduced from 60% to 48%. It applies to yearly income exceeding 40,968 N.S. (about US$ 25,605). Earned income (as well as modest income from housing rentals) enjoyed lower tax rates before 1987 and will continue to do so after 1987.

Earned income

Yearly income of 1 N.S. – 11,244 N.S. (about US$ 1 – US$ 7,027)	– 20%
Yearly income of 11,245 N.S. – 18,528 N.S. (about US$ 7,027 – US$ 11,580)	– 30%
Yearly income of 18,529 – 26,400 N.S. (about US$ 11,580 – US$ 16,500)	– 35%
Yearly income of 26,401 N.S. – 40,968 N.S. (about US$ 16,500 – US$ 25,605)	– 45%
Yearly income exceeding 40,968 N.S. (about US$ 25,605)	– 48%

Any other income

Yearly income of 1 N.S. – 26,400 N.S. (about US$ 1 – US$ 16,500)	– 35%
Yearly income of 26,401 N.S. – 40,968 N.S. (about US$ 16,500 – US$ 25,605)	– 45%
Yearly income exceeding 40,968 N.S. (about US$ 25,605)	– 48%

Housing rental income

Income from any housing rentals (not necessarily residential) is treated like earned income, provided that the taxpayer's total amount of income from all sources does not exceed 18,528 N.S. (about US$ 11,580). If the taxpayer's total yearly income exceeds 18,528 N.S., the amount of his rental income (subject) to the

1. Income Tax Ordinance Amendment Law (72), 5757-1987, *Sefer-HaChukkim* 1212, 9 April 1987, at 89.
The new law has been surveyed by the Revenue Administration in Income Tax (Legislation) Circular 3/87, 27 April 1987.
2. Tax year 1987 begins on 1 January 1987 and ends on 31 December 1987. Consequently, for the tax year 1987 the new individual tax rates apply to a period of 9 months, beginning on 1 April 1987, whereas the old rates of tax apply to the 3-month periods beginning on 1 January 1987. In order to prevent any problem which may arise, it has been laid down that 3/4 of the total taxable income for tax year 1987 should be related to the 9-month period beginning on 1 April 1987 and be taxed in accordance with the new tax rates and one forth of the income should be related to the period of 3 months ending on 31 March 1987, and hence be governed by the old tax rates.

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more favourable marginal rates of 20% (up to 11,244 N.S.) and 30% on the additional 7,284 N.S.), will be gradually reduced. The amount thus reduced equals the amount of total income exceeding 18,528 N.S. It follows that where the taxpayer's total income exceeds 37,056 N.S., all his income will be taxed as regular income, i.e. he will begin by paying 35% tax (up to 26,400 N.S., etc.). There is no similar proviso applying to earned income.

It should be noted that as of 1 January 1987 the "tax year" basis is no longer the "fiscal year", beginning on 1 April and ending 31 March of the next year, but the "calendar year", i.e. the tax year, begins on 1 January and ends on 31 December of the same year. The transition from the "fiscal year" to the "calendar year" required certain adjustments. Since the new individual tax rates apply as of 1 April 1987 further adjustments have been required.[3]

Provisional "surtax" of 10%

One should also note that the maximum marginal rate of 48% will apply only as of 1 January 1988. For the tax year 1987 (ending on 31 December 1987) individual taxpayers will have to pay a "surtax"; they will have to pay 48% + 10%, i.e. 52.8% on any amount of income exceeding 66,000 N.S. (about US$ 41,625) for the 9 months beginning on 1 April 1987 (i.e. a monthly income of 7,400 N.S., which is about US$ 4,625).

Because of their transitional nature the statutory provisions prescribing the necessary adjustments have not been dealt with in this note in more detail.

Dividend income

Before proceeding to deal with the new structure of corporate taxation, one should mention that the rate of income tax payable on dividends, received either by a non-resident corporation or an individual, has been fixed at a reduced rate of 25%. Prior to 1987 dividends were subject to a maximum tax rate of 45%.

Corporate tax rates

As already mentioned, the rate of income tax payable by the shareholder (who is either an individual or a non-resident corporation) is 25%.

As far as the corporation itself is concerned, the following changes should be noted: The rate of *corporation tax* has not been changed; it has remained 40%. The rate of *income tax,* however, has been reduced; as of the tax year 1987 (beginning on 1 January 1987) it will be 8⅓% (instead of 35%).

Consequently, the effective tax rate payable by the corporation on its undistributed profits will be 45% (instead of 61% before the 1987 Tax Reform). Suppose the undistributed profits amounted to 100. The corporation tax would be 40. Income tax would be paid at the rate of 8⅓% on 60 (100 − 40), i.e. 5. The total effective tax would therefore be 40 + 5 = 45.

If the corporation decides to distribute all its profits to its individual shareholders, the aggregate rate of tax paid both by the corporation and the shareholders would be 55% (instead of 67% before the 1987 Tax Reform). The figure 55% has been arrived at as follows: Corporation tax payable on 100 undistributed profits = 40. Income tax payable by the individual shareholders receiving 60 dividend at 25%, i.e. 15. The total tax payable would thus be 40 + 15 = 55. No income tax would be paid by the corporation since, for the purpose of computing the amount of income subject to income tax, both the corporation tax (amounting to 40) and the dividend distributed (amounting to 60) are deductible (100 − (60 + 40) = 0).

Corporations having an "approved enterprise" under the Law for the Encouragement of Capital Investment

Along with the reduction of the tax rates imposed on regular corporations, the tax rates on corporations having an "approved enterprise" have also been reduced. Corporations having an "approved enterprise", which had been approved before 30 July 1978 shall pay 35% tax (instead of 40%); those approved after 30 July 1978 shall pay 25% (instead of 30%).

The tax rates applicable to a "Foreign Investors Corporation" have not been changed. They have remained 20% (if the foreign investment constitutes 49% to 73%); 15% (if the foreign investment amounts to 73% − 89%); and 10% (if the foreign investment is 90% or more). The tax rates on dividends derived from the profits of "an approved enterprise" have also remained unaltered. A dividend from an enterprise approved after 30 June 1978 will remain subject to a tax rate of 15%.

It should be noted that the 1987 Tax Reform has also reduced the tax rates imposed on individuals and *Kibbuzim* who own "an approved enterprise", as well as corporations and individuals who own "an approved agricultural enterprise".

Industrial corporations

"Industrial corporations" enjoyed special privileges before 1987. Now that the tax burden on regular corporations has been reduced, there remained no need for the special treatment granted to "industrial corporations". Hence, subject to certain transitional reliefs, such corporations are treated by the 1987 Reform like regular corporations, and pay the same rate of tax. Certain tax benefits, however, have been retained, e.g. in the area of amalgamations, the right to deduct expenses incurred in the issuing of shares, depreciation allowance for patents and know-how, etc.

Capital gains tax

Before 1987, "inflationary capital gain" (i.e. the nominal capital gain derived from the sale of a capital asset because of the inflation, measured on the basis of the cost-of-living index) was subject to 10% capital gains tax. That has *not* been changed by the 1987 Reform.

The amount of capital gain exceeding the "inflationary gain" was treated as "real income", and charged to tax under the regular tax rates applied to "revenue" income, subject to a tax rate ceiling of 50% on the total amount of both the "inflationary" and the "real" cap-

3. See footnote 2, supra.

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ital gain. The principle of taxing the "real capital gain" like regular income has not been changed by the 1987 Reform. The rate of tax payable by a corporation on a "real" capital gain has, however, been adjusted. It has been reduced from 61% (before 1987) to 45%, thus adjusting it to the new reduced rate of tax payable by a corporation since 1987. An individual will pay on a "real" capital gain the regular marginal rate payable by him on his regular income. The top rate of capital gains tax paid by an individual would therefore be 48%. The statutory provision fixing the 50% ceiling has been rendered unnecessary and hence has been repealed.

Another change was made in the area of enforcement. Before 1987, a taxpayer realizing a capital gain had to pay to the Revenue, in advance, 40% of the gain, on account of the tax that would eventually be due from him. As of 1987 he will have to pay 30%. As before, the "payment on account" should be made within 30 days of the sale of the capital asset.

Miscellaneous

The 1987 Tax Reform also deals with matters other than the tax rates. They have not been discussed in this survey because they seem to be of less interest to the reader. Some of them are of a technical nature, e.g. adjustments of the rules of deduction at source (withholding) to the new scale of tax rates and adjustment of the machinery of indexation to the lower rate of inflation now prevailing in Israel.

Certain matters which are part of the Reform were dealt with by additional specific legislation. Worthy of particular mentioning is the taxation of certain payments of "personal allowances", which taxpayers receive in lieu of personal tax reliefs for maintenance of minor children. The tax on the "personal allowances" has been imposed by a special law enacted for this purpose. The law will be in effect only for the period of one year (from 1 April 1987 to 31 March 1988). The tax will be imposed only on taxpayers whose marginal tax rate is 45% or more. Taxpayers who receive personal allowances for 4 children or more shall be exempted from the tax.

Finally, it may be of some interest to note that the provisional legislation relating to adjustment for inflation has been made permanent. Income Tax Law (Adjustments for Inflation) (Provisional Law) 5756-1986 had been enacted provisionally for tax years 1985, 1986, 1987. On 31 March 1987 the Knesset (Israeli Parliament) passed an amendment to the provisional law, laying down that it would remain permanently, also after tax year 1987. However, the Minister of Finance has been empowered to rule that the law should not apply to a certain year. Such a ruling should be made not later than three months before the beginning of the tax year; it is also subject to the approval of the Finance Committee of the Knesset.[4]

CONCLUSIONS

There can be no doubt that the reduction of the tax rates by the Israeli Tax Reform of 1987 is a step in the right direction. Any marginal tax rate that exceeds 50% has an undesirable psychological effect on the taxpayer, who cannot understand why he has to pay to the Revenue, on any additional amount of income, more than he may retain for himself.

It is submitted, however, that since Israeli taxpayers have to pay (among other taxes, such as purchase tax) 15% value added tax, under a fairly comprehensive value added tax law, the reduction of the income tax rates by the 1987 Tax Reform was not enough. In any case, it is clear that the higher tax brackets should apply to much higher incomes, thus relieving the "middle income" taxpayers from their still too heavy burden of tax.

The new tax rates structure also calls for another comment relating to the distribution of dividends. Until the Tax Reform of 1975, closely-held corporations in Israel used to accumulate their profits, rather than distribute them, because the corporate tax was much lower than the top marginal tax rate of the individual. Since 1975, for the first time, the corporation has paid 61% tax, whereas the individual taxpayer has reached the top rate of only 60%.

The scheme which used to be practiced before 1975 was fairly simple. Individual taxpayers (or partnerships) conducted their business or profession in the legal form of a closely-held corporation. They got remuneration, as directors, for an amount that reached the individual marginal tax rate equivalent to the corporate tax rate. The remaining profits were retained by the corporation and were subject to the corporate tax rate, which was much lower than the top individual marginal rate. Thus, taxpayers managed to, in effect, lower their top marginal tax rate.

Under the 1987 Tax Reform, the tax rate paid by the corporation is again *less* than the maximum individual tax rate. This change may serve as a disincentive to distribute dividends and give rise to the old practice of incorporating in order to avoid tax by not distributing dividends.

Admittedly, the Income Tax Ordinance does contain a series of provisions empowering the Commissioner of Income Tax to counteract attempts to avoid tax by refraining from distributing dividends (Secs. 70-81). Experience, however, has shown that the implementation of those provisions have proved to be most problematic.

One should also admit that the difference between the corporate tax and the individual top marginal rate, under the *1987* Reform, is much less than it used to be *before 1975*. Therefore, it seems that there will now be less incentive to incorporate, receive remuneration reaching the 45% marginal rate, and retain the remaining profits within the corporation.

4. For more details on the Israeli legislation of adjusting the tax base to the inflation, see A. Lapidoth, "The Israeli experience of an inflation adjusted tax base – With special reference to the Income Tax Law (Adjustment for Inflation) Provisional Measures, 5755 (1985)", 40 *Bulletin for International Fiscal Documentation* 3 (1986) at 125.

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IFA AND GOLF

The annual golf tournament for the IFA Cup was held at the Royal Belgian Golf Club at Tervuren during the 1987 Congress. This was a most beautiful, and a most exclusive, club and thanks are due to Professor Sibille for arranging the event. The weather was good and the sixty competitors had a most enjoyable day including breakfast and a first class luncheon.

The standard of golf was good and competition was keen. There were two courses, one reserved for players with handicaps below twenty. The best score on the long course was Bruce Waugh from Canada with 39 points. Tom Brouwer from the Netherlands got 40 points on the easier short course and so it was decided that there should be "sudden death" play off between the two after lunch. This was watched by all and after great excitement Tom Brouwer emerged as the winner of the Cup for 1987.

Various other prizes were won including Mrs. Brouwer as the best accompanying person (39 points) and Maarten Ellis with the best score for a non-handicap player (47 points!). Best gross score of the day went to P. Sundgren from Sweden.

Overall it was a good day especially for the Dutch who will have the honour of defending the Cup as well as organizing the competition in the Netherlands next year.

NETHERLANDS BRANCH

On 4 October 1987 the Netherlands Branch of IFA held its annual meeting in Amsterdam.

Officers

Prof. J. van Hoorn Jr. retired as Honorary Treasurer, a post which he has held for over 40 years. Mr. J.F. Spierdijk, Honorary Secretary, paid homage to him for his important contribution to IFA's work during so many years. Apart from administering the Netherlands Branch's funds, Prof. van Hoorn served IFA as General Reporter and Chairman of Seminars during a number of its Annual Congresses and played an important role in the Permanent Scientific Committee.

Mr. A. Overbosch was appointed as Prof. van Hoorn's successor.

Amsterdam Congress of IFA in 1988

In 1988 IFA will celebrate its 50th Anniversary in Amsterdam and the Netherlands Branch will host this important event which will take place from 11-16 September 1988. During the 1987 Brussels Congress a pamphlet was distributed which gave an outline of the scientific and social programme. The two subjects which will be discussed are:
Subject I: Recognition of foreign enterprises as taxable entities; and
Subject II: Tax treatment of computer software.

On 14 September 1988 two simultaneous seminars will be organized:
Seminar A: Data processing in taxation; and
Seminar B: Tax consequences regarding pension provisions for the internationally transferred employee.

On 16 September 1988 there will also be two simultaneous seminars:
Seminar C: Recent issues in tax conventions; and
Seminar D: Draft EC Directives on parent-subsidiary, on mergers and on arbitration.

During the Congress a special exhibition on computer use and applications in the tax field will be organized. The Netherlands Ministry of Finance will show the workings of an automatized tax office.

The social programme will include the opening ceremony to be held in the 15th century "New Church" on the Dam Square, a performance by the Concertgebouw Orchestra and a reception hosted by the International Bureau of Fiscal Documentation in the Maritime Museum, a lecture on the work and life of Van Gogh and a "Dutch Soirée" in the auction hall for flowers in Aalsmeer. The excursions which will be offered include a trip to the Delta Works, the Open-Air Museum near Arnhem, the old fishermen villages of Volendam and Marken, the new reclaimed land of the former Zuyder Zee, and Delft, the town of Vermeer. Also a golf tournament will be organized.

Congress reports

The greatest part of the meeting was dedicated to the (lively) discussion of the draft reports which will be submitted during the Amsterdam Congress. The report on the first subject: *Recognition of foreign enterprises as taxable entities* was submitted by Mr. A. Boekhoudt, Tax Inspector in Amsterdam, and the report on the second subject: *Tax treatment of computer software,* by Dr. H. Kogels, Fiscal Adviser of Philips International B.V.

SWISS BRANCH

On 29 October 1987 the Swiss Branch held a special meeting in Neuchatel to discuss the following subjects:

(1) The results of the Annual Congress held in September 1987 in Brussels. Dr. S. Zimmerman and Dr. N. Burki commented briefly on Subject I (The

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fiscal residence of companies) and Subject II (Tax treatment of the liquidation of companies) respectively.

(2) The subjects of the 1988 Congress which will be held in Amsterdam. These were commented upon by Dr. R. Oesch (Subject I: Recognition of foreign enterprises as taxable entities) and by Mr. E. Hess (Subject II: Data processing in taxation).

(3) Mrs. G. Laffely gave a talk on the tax incentives to further the ownership of dwelling-houses.

(4) Dr. iur. F. Bertossa, LL.M., informed the audience on the progress made by Swiss-Lex which is setting up a data bank for Swiss law.

Bibliography

Books

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

To facilitate ordering, a list of addresses of the main publishing houses is included on pages 46-48 of the January 1986 issue. Addresses of publishers which do not appear in this list are indicated in the item concerned.

AFRICA

Cameroon

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Calcutta, Eastern Law House, 1987, 418 pp.
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Seoul, Ministry of Finance, 1987, 71 pp.
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(B. 57.012)

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Updated general information guide on foreign investment policy, procedures and incentives and other relevant issues for doing business in Korea.
(B. 57.009)

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POINTON, Leo D.
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Singapore, Butterworths & Co (Asia) Pte Ltd., 30 Robinson Road, 12-01 Tuan Sing Towers, Singapore 0104, 1986, 281 pp., S$ 75.
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- payments under the Dutch students' Finance Law
- transfer of single premium life insurance policy to resident taxpayers
- the deduction of car costs as extraordinary expenses
- changes in the law on value added tax
- subsidies for employing long term unemployed

The "Fiscette" is published in cooperation with the "Nederlandse Orde van Accountant-administratieconsulenten (NOvAA)".

Every month, apart from July and August, a new "Fiscette" is issued for Dutch speaking people.

The subscription price is 150 Dfl. per one year and can be ordered from Kluwer, P.O. Box 23, 7400 GA Deventer, the Netherlands
Telex 49295 Telefax 05700-3 47 40.

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